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Nexus and Multistate Sales Taxes:

A Changing Landscape for Retailers

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State laws governing sales and use tax for transactions that cross state lines are complex, frequently changing, and currently the subject of intense debate in state legislatures, the U.S. Congress, and state and federal courts. As online remote sales continue to grow, states are looking to level the playing field so that all retail transactions – in-store and online – are taxed equally, and recoup uncollected tax revenue from online transactions.

Retailers that sell to consumers in states where the sellers aren't registered to collect and remit sales tax find themselves in a shifting landscape, warily watching both federal and state laws that promise to transform their legal obligations regarding managing sales tax.

Much of the debate hinges on the determination of which retail activities undertaken in a given state create a specific type of legal connection to the state, a concept known as nexus. Most commonly defined as "sufficient physical presence," nexus means that a business has a connection to a state such that the state is permitted to tax its transactions according to the U.S. Constitution.[1] In the case of sales tax, having nexus in a state means a business must collect and remit taxes on sales to customers in that state. Each state sets its own parameters for nexus.

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The activities that create nexus in many states are already more numerous than many retailers realize, and as states expand nexus rules around remote sales, that number is growing. Retailers are particularly affected by changes in nexus laws related to sales into other states. It's essential for retailers to know whether or not their sales into other states trigger an obligation to collect and remit sales tax under each state's nexus rules.

Nexus, Then and Now

Legislation concerning nexus is nothing new; courts have been debating the principles involved since at least 1939, and the word itself has been associated with tax law since 1967.[2]

The legal basis states have for taxing out-of-state businesses comes directly from the U.S. Constitution: The U.S. Commerce Clause governs the taxation of interstate commerce,[3] and the Due Process Clause requires that a minimum connection must exist between a state and the person, property, or transaction it seeks to tax.[4]

The U.S. Supreme Court has been called upon at various times to clarify the intent of these clauses. In 1977, the Court ruled in *Complete Auto Transit, Inc. v. Brady* that there must be "substantial nexus" between the taxing state and the taxed entity.[5] In 1992, the Court found in *Quill Corp. v. North Dakota* that nexus constitutes a "physical presence" in the taxing state.[6]

In recent years nexus has been a focus of renewed debate as states work to recoup tax revenue from skyrocketing ecommerce, which increased 15 percent from 2015 to 2016, when online sales in the U.S. totaled $394.9 billion.[7] As such, the last decade has seen a huge expansion in the strength and breadth of nexus laws. In 2017, most notably, close to 20 states pushed for economic nexus standards through legislative or regulatory changes.[8]

"For retailers, sales tax compliance can be a moving target."

These rules would make certain out-of-state retailers responsible for collecting and remitting sales tax even without entering the state, a change that constitutes a major shift in the common understanding of nexus and a direct challenge to the U.S. Supreme Court's definition of it. It is no surprise that there are challenges and delays to implementation in five of the 14 states that have created such rules.[9]

For retailers, sales tax compliance can be a moving target. As the example of states' pursuit of economic nexus rules makes clear, nexus laws are ever-changing and expanding in various forms in many states. Data provided by Bloomberg Tax's *2017 Survey of State Tax Departments* highlights some issues that retailers should pay attention to when it comes to nexus, such as which activities create nexus, sourcing rules, and nexus rules for drop-shipping.

In many states, for example, making sales while in the state for just a few days will give you nexus, as will sending an employee to meet with a supplier there. Soliciting sales in a state through advertising is likely to create nexus there, and a few states even hold that entering a state you sell into a certain number of times will give you nexus. Retailers that sell into other states need to pay attention to rules that dictate which state collects the sales tax on the transaction – the buyer's or the seller's. And retailers that use drop-shippers must be alert to where this relationship may give them 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."

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1 Sales Tax Institute, "What Is Nexus?", http://www.salestaxinstitute.com/Sales_Tax_FAQs/What_is_nexus
2 June Summers Haas, "Due Process, Economic Presence, Nexus and Electronic Commerce," April 22, 2016, https://www.bna.com/due-process-economic-n57982070221/
3 U.S. Constitution, (Article I, Section 8, Clause 3), https://www.law.cornell.edu/constitution/articlei#section8
4 U.S. Constitution, 14th Amendment, https://www.law.cornell.edu/constitution/amendmentxiv
5 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
6 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
7 U.S. Department of Commerce, "U.S. Census Bureau News," February 17, 2017, https://www2.census.gov/retail/releases/historical/ecomm/16q4.pdf
8 Bloomberg Tax, "Cross-Border Sales Tax a Growing Issue for Companies: Panelists," Dec 1, 2017, https://www.bna.com/crossborder-sales-tax-n73014472654/
9 Sales Tax Institute, "Remote Seller Nexus Chart," http://www.salestaxinstitute.com/resources/remote-seller-nexus-chart

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 Tax'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.

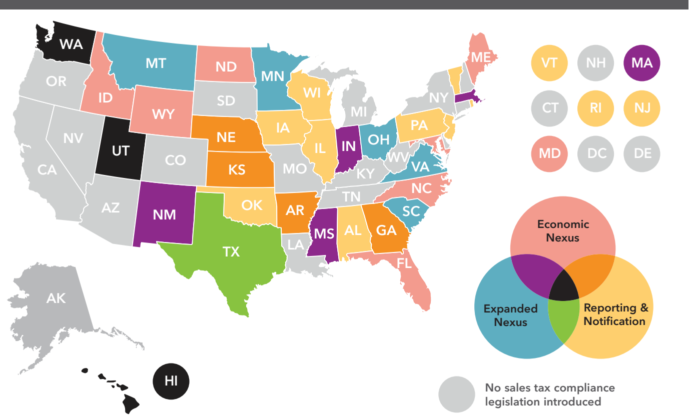
Economic Presence: A business can also create a substantial connection to a state without setting foot in it. The economic presence standard has historically been applied to nexus for state income tax, but many states have expended it to sales tax laws in recent years. This standard is based on a business'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

Alabama, Maine, Massachusetts, Mississippi, Pennsylvania, Vermont, and Washington 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 that have economic nexus legislation that is being challenged or delayed are Indiana, North Dakota, South Dakota, Tennessee, and Wyoming.

Factor Presence: This standard combines physical and economic presence requirements, setting out thresholds that business 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": $50,000 of property, $50,000 of payroll, and $500,000 of sales, or 25 percent of total property, total payroll, or total sales.[10] 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.

State Sales and Use Tax Compliance Legislation

Introduced legislation as of July 10, 2017



Source: MultiState Insider: https://www.multistate.us/blog/sales-tax-compliance-legislation-is-still-a-hot-topic-at-the-state-and-federal-level

Redefining Nexus

As states substantially broaden their definitions of what creates nexus, federal lawmakers have introduced various pieces of legislation that seek to standardize approaches to nexus across states: Marketplace Fairness Act of 2017 (S.976; introduced), Remote Transactions Parity Act of 2017 (H.R.2193; referred to subcommittee), Online Sales Simplification Act (discussion draft introduced), and No Regulation Without Representation Act of 2017 (H.R.2887; introduced).

The Marketplace Fairness Act and the Remote Transactions Parity Act would allow states to require out-of-state sellers to collect and remit taxes on sales in a state whether they have nexus in that state or not. Both provide exceptions for small sellers, and the latter provides exceptions for catalog-only sellers. Under the Online Sales Simplification Act, states participating in a clearinghouse would collect sales tax only from sales originating in the state. The No Regulation Without Representation Act seeks to codify the definition of nexus put forward in *Quill* and limit what activities can be used as a basis for nexus.

With Congress continuing its habitual dormancy on issues of interstate taxation, none of these proposed pieces of legislation are likely to progress toward law anytime soon. The U.S. Supreme Court, meanwhile, for years has consistently denied *certiorari* in cases involving nexus. Faced with inaction at the federal level, states have become more aggressive in enforcement and expansion of state-based nexus regulations, some of which present a direct challenge to existing federal law.

Enforcing Use Tax

Along with attempts to expand nexus rules, some states are addressing the question of how to collect more sales tax by introducing new use tax reporting laws.

Consumers who have not paid *sales tax* on a taxable transaction – usually due to the seller not having nexus in the state and therefore not collecting sales tax – owe the state that money in the form of *use tax*. Historically, few consumers voluntarily remit use tax owed on eligible transitions. Use tax reporting requirements turn the tables and put the onus on sellers to report use tax owed on behalf of their customers.

"Retail businesses face an increasing likelihood of establishing nexus or being required to collect sales tax in more states."

Six states – Alabama, Colorado, Louisiana, Pennsylvania, Vermont, and Washington – have implemented use tax reporting requirements that direct non-collecting sellers to share transaction information with state tax authorities. State departments of taxation can use this buyer information to collect use tax from in-state consumers. Meanwhile, Kentucky, Oklahoma,

[10] 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

Rhode Island, South Dakota, and Tennessee require out-of-state retailers to officially notify customers that they owe use tax, but are not required to report this information to state tax authorities.[11] Quite a few other states are now considering some version of these rules, including Arkansas, Georgia, Kansas, Hawaii, Nebraska, and Utah.[12]

Rules that require businesses to supply information on consumers' spending activity to state taxation departments are raising concerns about consumer privacy. Regulations that mandate notifying customers about their use tax obligations also raise objections due to the heavy new administrative burdens they would impose on businesses.

Retailers, Nexus, and Sales Tax

As the shifting landscape of sales tax law makes clear, retail businesses face an increasing likelihood of establishing nexus or being required to collect sales tax in more states – if not eventually all of them.

Bloomberg Tax's *2017 Survey of State Tax Departments* investigates several issues that pertain to retailers who sell across state lines, including nexus-creating activities, sourcing rules, and nexus rules for drop-shipping.

Creating Nexus

Many activities associated with retail business can create nexus, including selling while in a state temporarily, getting online click-through referrals, working with affiliates and unrelated parties, picking up items in a state or simply entering a state, soliciting sales, and drop-shipping, to name a few.

Temporary or Sporadic Presence

Retailers who enter a state temporarily may create nexus with a variety of activities, including attending or selling at trade shows, making sales while there temporarily, attending or holding seminars, or having an employee meet with suppliers. Traveling to a state multiple times may also create nexus. While most states don't find that simply attending a trade show or seminar creates nexus, 33 states say that making a sale or accepting orders at a trade show does. Most states say that holding at least two one-day seminars creates nexus, and 36 states indicate that making sales while in a state for fewer than four days does as well.

Click-Through Nexus

Retailers who have arrangements with affiliates that use internet tools for referrals must be aware of potential nexus entanglements. Of those surveyed, 18 states say that using an internet link or entering into a linking arrangement with a third party in the state gives a retailer nexus if the arrangement results in sales under $10,000. If the relationship produces more than $10,000 in sales, 27 states find this to be a nexus-creating situation. Hiring a third party in a state to refer customers via a link – called "click-through nexus" – is sufficient to create nexus in 15 states.

Working with Affiliates and Unrelated Parties

Retailers who work with third parties to conduct various aspects of business in a state are likely to create nexus. The majority of states indicate that using an in-state affiliate to sell property or accept returns creates nexus. Working with an in-state affiliate to run a loyalty points program qualifies a company for nexus in 33 states, and selling gift cards in affiliated in-state stores creates nexus in 27 states.

Hiring third parties that aren't officially affiliated with a company can also create nexus. Such activities include hiring independent contractors to perform warranty services; hiring unaffiliated printers, call centers, or collections agencies; advertising in local media or producing an infomercial; using an in-state company to drop-ship merchandise; and shipping goods to a distribution center in the state.

Delivery and Distribution

Most states consider that a company creates nexus when it enters the state to pick up defective products or to pick up goods that have been delivered to a central location in the state for onward delivery elsewhere. Five states consider nexus to be created when a company that sells remotely into the state simply enters the state a certain number of times – possibly even once. Delivering goods into a state via contract carrier can also create nexus; 14 states report that it does.

Third-Party Solicitation

Many states find that soliciting sales in a state – whether through advertising or more direct solicitation – is activity that creates nexus. A majority of states find that distributing flyers, coupons, and other printed promotional materials into the state creates nexus. Conversely, distributing electronic promotional materials rarely does – only five states find that creates nexus. States unanimously agree that soliciting sales in person creates nexus but are more likely than not to say that soliciting sales by telephone does not. A large majority of states say that demonstrating a product in person creates nexus; only four states say that it does not.

Sample Nexus Use Case

The CEO of Just In Time Watches, a fictional North Dakota watchmaker, drove through South Dakota in January to visit its warehouse in Nebraska. To date, Just In Time had never made a sale to a customer in South Dakota, so his business had no connection to the state. In February, a customer in South Dakota bought a watch from the company online. Just In Time did not charge the customer sales tax since it didn't have nexus in South Dakota. In March, when the CEO made his next trip to the warehouse, passing through South Dakota created nexus for Just In Time, since South Dakota holds that nexus is created when a company that sells into the state enters the state. When that first South Dakota buyer purchased a watch for her husband in April, Just In Time had to charge her sales tax.

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11 Sales Tax Institute," Remote Seller Nexus Chart," http://www.salestaxinstitute.com/resources/remote-seller-nexus-chart

12 Emilie Burnette, "Sales Tax Slice: You Spent How Much on Shoes?! State and Local Governments are Demanding More Transparency Regarding Use Tax Liability," Bloomberg BNA SALT Talk Blog, https://www.bna.com/sales-tax-slice-b57982084268/

Sourcing Transactions

The 45 jurisdictions that impose a sales and use tax have established "sourcing" rules that dictate which jurisdiction gets to receive the tax revenue resulting from the transaction – the seller's location ("origin-based" sourcing) or the buyer's ("destination-based" sourcing).

Since goods are usually taxed at the location where they are to be used or consumed, most states use destination-based sourcing. But rules differ from state to state and vary based on the product or service, the type of transaction, and the mode of delivery. States may also vary rules for interstate versus intrastate transactions. Retailers should know the sourcing rules for states in which they have nexus.

Drop-Shipping

Drop-shipping and three-way transactions make nexus rules even more complex. Sales tax errors are most likely to appear in drop-shipping transactions; retailers must be particularly alert about the details of the sales and the impact nexus rules have on their sales-tax obligations.

Bloomberg Tax's *2017 Survey of State Tax Departments* asked senior state tax officials how their states determine sales tax nexus for activities related to drop-shipping transactions. States usually consider activities undertaken by both the distributor (retailer) and the manufacturer to potentially create nexus. For example, 22 states said nexus is created if an in-state manufacturer holds title to the inventory until the retailer directs the manufacturer to ship the order, while 35 states said nexus is created if the retailer holds title to the inventory.

If either the retailer or the drop shipper has or creates nexus in a customer's state, whichever entity has nexus may be responsible for collecting sales tax (or providing the appropriate exemption documentation). When working with a drop shipper, a retailer should always check the circumstances under which the state where the product is being delivered requires a drop shipper with nexus to charge sales tax – and whether the transaction itself creates nexus. If both the retailer and the drop shipper have nexus in the state, it's important to work together to avoid double-charging sales tax or letting it slip through the cracks.

Sample Drop-Shipping Use Case

Pretty Pinafores, a Florida-based children's clothing company, works with manufacturers in Colorado and California to drop-ship products. These two manufacturers hold title to the inventory until the retailer directs them to ship it out. One day, a customer in California orders a dress and a customer in Colorado orders a sweater. Each manufacturer ships the given product to the in-state customer via UPS. Pretty Pinafores does not gain nexus in California, in which drop-shipping using a manufacturer with title to inventory does not create nexus. (However, if the retailer had held title instead, the transaction would have given the company nexus in California.) Pretty Pinafores does gain nexus in Colorado, since the rules there dictate that nexus is created by drop-shipping from a manufacturer in the state whether or not it holds title to the inventory.

Conclusion

Bloomberg Tax's *2017 Survey of State Tax Departments* makes clear that retailers must be alert to the details and changes in state sales-tax laws. Retailers are subject to a vast array of nexus rules and are likely to engage in a large range of activities that create nexus. They are at most at risk of noncompliance from the simple inability to keep up with all the various permutations of nexus law, especially as it changes rapidly in the era of ecommerce. They must also be alert when engaging in complex transactional relationships like drop-shipping – one of the thorniest domains of sales-tax regulation.

"Retailers are subject to a vast array of nexus rules and are likely to engage in a large range of activities that create nexus."

Automating sales tax tracking and compliance is a best practice for retailers. It is extremely time- and energy-consuming – a Herculean effort, really – to manually track the rules and regulations that apply to retail activities, and always file accurate and timely returns. Automating sales-tax management allows retailers to concentrate on what they do best: selling great products.

This white paper cites results of Bloomberg Tax's 2017 Survey of State Tax Departments.[13] *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.

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

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