

## Nexus Reviews: Uncovering New State Sales or Income Tax Obligations

THURSDAY, MAY 14, 2015 1:00-2:50 pm Eastern

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# Nexus Reviews

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May 14, 2015

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# REVIEW OF CURRENT NEXUS TRENDS

Mark A. Loyd, Bingham Greenebaum Doll

# *Review of Current Nexus Trends*

## Overview:

### A. Sales and Use Tax

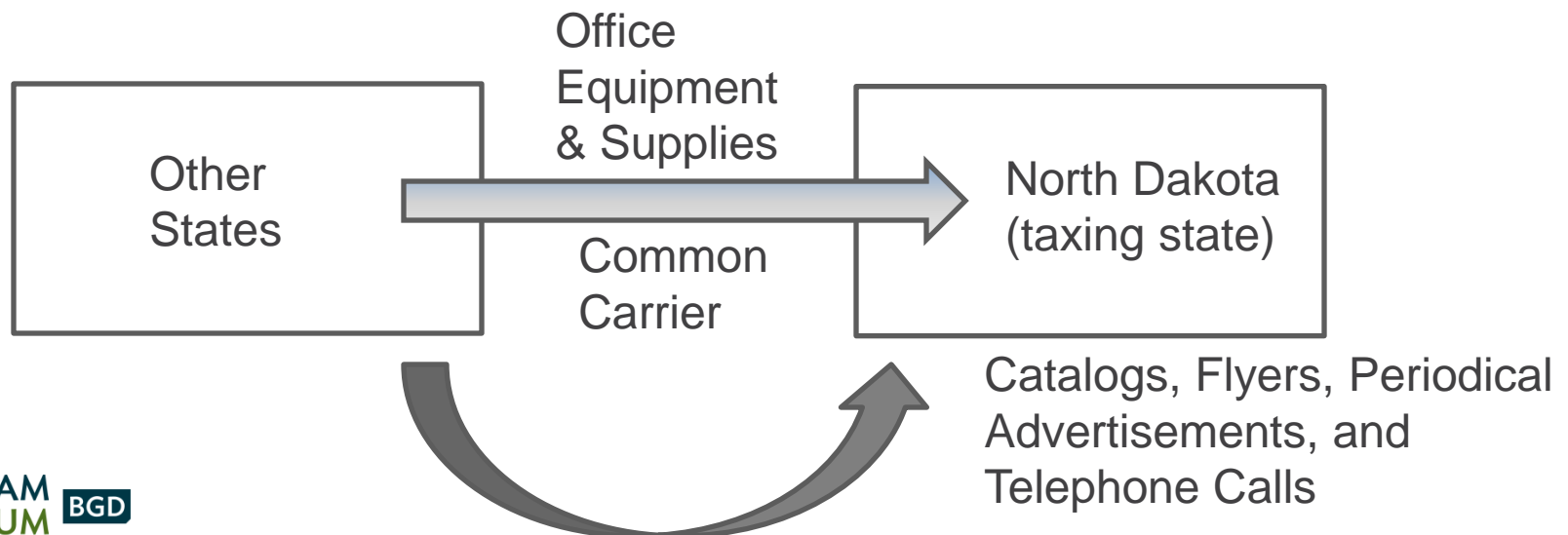
- 1) Physical presence standards
- 2) Evolving areas - “Amazon taxes” and online marketing activities

### B. Corporate Income Tax

- 1) Nexus standards for income taxes on businesses
- 2) Evolving areas - agency nexus, warrant provider nexus, etc.

# Commerce Clause Requires Physical Presence for Sales Tax Nexus

- Complete Auto Test Requires - “Substantial Nexus”
- *Quill Corp. v. North Dakota* (1992) (Sales Tax) - Substantial Nexus Requires Physical Presence





# *Common Sales Tax Nexus-Triggering Activities Involving Physical Presence*

- Physical Presence - *Quill*
  - Property
    - Real Property - Land, Building, etc.
    - Personal Property
    - Leased Property - Office, etc.
  - Payroll (Employees) - Unemployment Wages, Withholding Wages, etc.
  - Exception for *De Minimis* property, e.g., software - *Quill*
- Attributional Nexus (so-called indirect physical presence through another)
  - In-State Representatives, e.g., Independent Contractors who help to maintain a market - *Scripto; Tyler Pipe*
  - Click-Through Nexus Statutes (so-called “Amazon Statutes”)

# *Evolving Sales Tax Nexus Standards: Direct Marketing Ass’n v. Brohl – Challenge to Quill Encouraged!*

- Justice Kennedy in Concurrence:
  - “Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court’s holding in Quill. A case questionable even when decided. Quill now harms States to a degree far greater than could have been anticipated earlier.”
- Look for Quill override case to go up?
  - Remember: *Quill* itself was a National Bellas Hess override case!

## *Evolving Sales Tax Nexus Standards: Click-Through Nexus Statutes (“Amazon Statutes”)*

- Remote Vendors (e.g., online sellers) with no physical presence in a state cannot be compelled by that state to collect sales taxes, under *Quill*
- Taxpayers owe use tax when sales tax not paid on their taxable purchases from out-of-state vendors
  - Businesses often self-report use tax
  - Trend for states to facilitate self-reporting of use tax by consumers

## *Evolving Sales Tax Nexus Standards: Click-Through Nexus Statutes, Etc.*

### Marketplace Fairness Act (MFA) of 2015 (S. 698)

- Requires remote vendors to collect sales tax [*Quill* override]
- Requires states to meet simplification criteria
- Out-of-state sellers get collection software

# *Evolving Sales Tax Nexus Standards: Click-Through Nexus Statutes, Etc.*

States' efforts to force remote vendors to collect sales tax:

- **Use Tax 1099-like Information Reporting** (CO & NC)
- **Amazon Laws** NY's 2008 law: Click-through nexus statutes (agreement with resident to refer customers via an internet link or otherwise) and rebuttable presumption of nexus
- **Affiliate Nexus Laws** [MTC Model Statute based on CA]
- **In-State Delivery Arrangements:** Arrangements, with other than a common carrier, to facilitate delivery of property to in-state customer at an in-state location
  - Indiana 2014 proposed legislation (did not pass)
- **Use Tax Notification:** Requirement to notify customers of requirement to report use tax (e.g., CO, KY & OK)
- **Warranty Nexus:** In-state contractors performing warranty & repair work
- **Marketplace Facilitator** - New York (recently rejected) and Washington (HB 2224) have proposals to attribute nexus if sales made through a facilitator (e.g. E-Bay) - Washington would also include use of credit card or other payment facilitator plus factor nexus (\$267k in sales)

# *Evolving Sales Tax Nexus Standards: State Laws Requiring Information Reporting*

- **Use Tax Information Reporting Laws:**
  - Colorado (2010 law): Collect sales tax or notify customers of obligation and report customers' purchases; enforcement enjoined in *Direct Marketing Association v. Department of Revenue* (Feb. 2014)
  - North Carolina (2010): NC sought details on customers' purchases from Amazon and other online retailers; federal District Court ruled this violated free speech & privacy rights.

# *Evolving Sales Tax Nexus Standards: Direct Marketing Ass'n v. Brohl – Co. Use Tax Reporting Scheme*

## **Colorado Use Tax Information Reporting Scheme**

- Non-collecting Retailer Must Notify Colorado Purchasers that Colorado Sales or Use Tax Is Due on Purchases and Colorado Requires Purchaser to File a Sales or Use Tax Return
  - Penalty of \$5 Per Transaction for Failure to Notify
- Non-collecting Retailer Must Provide Report to Colorado Purchasers (with > \$500 purchases) Listing Purchases
  - Penalty of \$10 Per Report for Failure to Send Reports
- Non-collecting Retailer Must Provide Report to Colorado Listing Colorado Purchasers, Addresses and Total Amounts
  - Penalty of \$10 Per Purchaser Omitted from Report

Enforcement is currently enjoined.

# *Evolving Sales Tax Nexus Standards: Direct Marketing Ass'n v. Brohl – Does TIA Bar Federal Challenge?*

- Tax Injunction Act provides that federal district courts “shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State.” 28 USC § 1341.
- Colorado Use Tax Reporting Scheme Not an Assessment, Levy or Collection of tax - so - Not Bar
  - More State Cases in Federal Court? But, What about Comity Doctrine?
  - TIA and Comity Remain Hurdles
- USSC Did Not Address Comity Doctrine (which counsels federal courts to refrain from interfering with fiscal operations of state governments)



## *Evolving Sales Tax Nexus Standards: Click-Through Nexus Statutes (“Amazon Statutes”)*

- **Amazon Laws:** Click-through nexus statutes (agreement with resident to refer customers via an internet link or otherwise) typically coupled with a presumption of nexus when annual referred sales exceed \$10,000
  - Amazon Laws and Variants: Arkansas, Colorado, California, Connecticut, Georgia, Illinois, North Carolina, Pennsylvania, Rhode Island, Texas, Utah, and Virginia
  - New York (2008): SCOTUS denied *certiorari* of *Amazon & Overstock* challenges
  - Illinois: Internet Tax Freedom Act (ITFA), P.L. 105-277, which prohibits states from imposing discriminatory taxes on electronic commerce, preempted Illinois’s click-through nexus law per *Performance Marketing Ass’n v. Hamer* (Ill. Oct. 18, 2013)

## *Evolving Sales Tax Nexus Standards: Warranty Provider Nexus*

- **Warranty Provider Nexus:** out-of-state vendors that employ others to perform in-state warranty and repair work
- The MTC has taken the position that: “The industry practice of providing in-state warranty repair services through third party repair service providers...creates constitutional nexus for imposition of use tax collection responsibility for all sales made to customers in that State...in the taxing State where the warranty services are performed.” MTC Bulletin NB 95-1
- AL, AZ, AR, CO, CT, DC, FL, HI, ID, KS, MD, MI, MN, MO, NE, NJ, NM, ND, TX, UT and WA, but not CA

# *Corporate Income Tax Nexus: Commerce Clause Requirements*

- *Complete Auto* Test Requires - “Substantial Nexus”
- State Courts Tend to Opine that Physical Presence Not Required, but SCOTUS Has Not Opined
  - *Tax Comm’r of W.Va. v. MBNA America Bank, N.A.* (W.Va. 2006) - Continuous and Systematic In-State Solicitation and Promotion Is Significant Economic Presence Sufficient to Create Nexus
  - *Griffith v. ConAgra Brands, Inc.* (W.Va. 2012) (Income Tax) - Placement of Trademarks and Trade Names in Stream of Commerce via Licensees’ Products Is Insufficient to Create Nexus

# *Corporate Income Tax Nexus: Due Process Clause Requirements*

- Due Process requires a “Minimum Connection”
- What is a Minimum Connection?
  - General Jurisdiction versus Specific Jurisdiction
    - General - Continuous and Systematic General Business Contacts
      - *Goodyear Dunlop Tires Operations, S.A. v. Brown* (2011)
    - Specific - Purposeful Availment (“Targeting” the Forum Required?)
      - *J. McIntyre Machinery, Ltd. V. Nicastro* (2011)

# *Common Nexus-Triggering Business Activities*

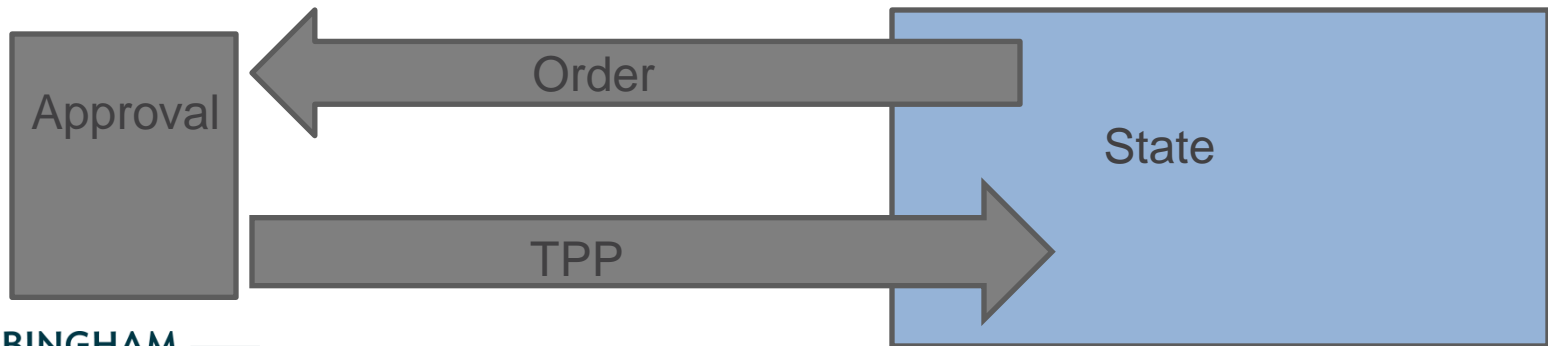
State Tax Statutorily Defined Nexus Requirements - Subject to Constitutional Constraints

- Doing Business (coextensive with constitutional standards)
- Bright Line Factor Nexus
  - Based on Defined Level of Property (e.g., \$50k or 25%), Payroll (e.g., \$50k or 25%) or Sales (e.g., \$500k or 25%)
  - Examples: Ohio (CAT), Michigan, California, Colorado, Connecticut, Oklahoma (BAT), Washington (B&O)

# *P.L. 86-272*

## *Income Tax Exception from Nexus*

- P.L. 86-272 Enacted by Congress in 1959 Provides Exception from Nexus (15 U.S.C. §§ 381 to 384)
- Response to *Northwestern States Portland Cement Co. v. Minnesota*, upholding imposition of income tax on out-of-state corporation that solicited orders and maintained an in-state office
- Restricts a state from imposing an income tax when a business' only activity is the solicitation of orders for tangible personal property in the state that are approved and filled from outside of the state



# *P.L. 86-272*

## *Income Tax Exception from Nexus (Cont'd)*

- Protection Does Not Extend to:
  - Imposition of Tax by State of Incorporation
  - Sales of Services
  - Income from Intangibles
- Examples of Activities That May Not Be Protected
  - Repairs
  - Installation
  - Collections
  - Repossessing
  - Picking Up Damaged Goods
- *De Minimus* Activities?

## *Evolving Areas: Agency Nexus, Warranty Provider Nexus, Etc.*

- **Attributional Nexus:** Nexus attributable to the activities of others in a taxing state with which the taxpayer has a relationship (e.g., agent, affiliate, contractor, etc.)
- **Agency Nexus:** Use of an agent with a physical presence in the taxing state creates nexus [e.g., *Scripto & Tyler Pipe*]
- **Warranty Provider Nexus:** Out-of-state vendors that employ others to perform in-state warranty and repair work [MTC Bulletin NB 95-1]



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# Sales Tax Nexus Reviews

**May 14, 2015**

**Mark W. Yopp**

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- Why do a nexus questionnaire/nexus review?
  - For an ongoing business
    - Get a better sense of the company's exposure & quantify the risks
    - Determine what path forward is needed
      - File Returns going forward
      - Request voluntary disclosure agreement
      - Amnesty
      - Review potential restructuring options
  - Acquisition
    - Due Diligence
    - Determine how to approach escrow or allocation of liabilities

- How do you conduct a nexus review?
  - Internal vs. Third party
    - Privilege issues with using an accounting firm/Kovell
  - Formulating questions
    - Sample Questions; Questions from state questionnaires.
    - Should be done based on the company's industry
  - Could distribute written questions first
    - Can be sent to tax department to do initial fact gathering
  - Interviews with the businesses

- General Categories of activity
  - Assets/Property
  - Employee Activities
  - Third-party activities
    - Activities by employees of affiliates
  - Registrations
- Sample Questions

## ■ Assets/Property

- Does the company own/rent any real property?
- Where is inventory located?
  - Flash title/Drop shipments
- For digital products and software, where are servers located?

## ■ Employee Activity

- For sales tax nexus, where have the employees been traveling?
  - Is there a tracking system in place?
  - Expense reports?
- Is the presence *de minimis*?

- Third-Party Activities – What are the third parties doing?
  - Warranty or repair activities
  - Assembly/installation
  - Customer Service
    - Where is the customer service center located?
    - Is it only for specific states?
  - Training of customers/resellers
  - Drop shipment/wholesale/distribution activities
  - Procurement?
  - Servers



- Affiliates/Related entities
  - Same concerns as third parties
  - How are the services provided?
    - Leased employees
    - Intercompany services contract

## ■ Registrations

- Registration to do business
- Registration for specialty businesses (e.g. pharmaceuticals, alcohol/wine sales)
- Need to know all places where the company is filing any tax returns

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# *Identifying Company Staff and Departments to Receive Questionnaire*

# *Who Should Complete the Questionnaire*

- Nexus Questionnaire Resources
  - Tax Department
  - Legal Department
  - Sales/Marketing Department
  - Business Operations Department
  - Human Resources
  - Management

## *Who Should Complete the Questionnaire*

- Tax Department
  - Tax returns
  - Apportionment
  - Tax audits
  - Tax notices
  - Tax strategies
  - Knowledge of state taxes
- Legal Department
  - Form and dissolve legal entities
  - Contracts and agreements
  - Register to do business
  - Legal entity structure

# *Who Should Complete the Questionnaire*

- Sales and Departments
  - Sales representatives
  - Trade shows
  - Agency relationships
  - Check inventory levels of customers or distributors
  - Provide services (i.e., installation, repair)
  - Internet sales
- Marketing Department
  - Advertising
  - Trade shows
  - Where is marketing literature sent
  - Advertise in local media through television, radio, newspaper, billboards

# *Who Should Complete the Questionnaire*

- Human Resources
  - Office locations
  - Hire and fire employees
  - Independent contractors
  - Remote employees
  - File payroll tax returns
- Operations
  - Factories
  - Distribution Centers
  - (owned or leased)
- Management
  - Headquarters
  - Officers and Board of Directors



# *Who Should Complete the Questionnaire*

Answers?

- Yes
- No
- Explanation

Not responding to or ignoring a state nexus questionnaire

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- Critical to have upper management involved and active in the process.
  - Helps the tax department obtain information and involvement from other departments.
- How to obtain upper management involvement?
  - Financial – Compare the potential penalties with the cost of a nexus review and subsequent action.
  - Reputational – Hit to the company if seen as not paying taxes.
  - Personal – For sales and use taxes, responsible officers can typically be liable for unpaid taxes.

- Need to have buy-in not just on the process but the next steps.
- Steps
  - Determine potential tax filings so that management is prepared for the increase in tax payments.
  - Pros and Cons of the different options.
  - Costs and benefits for ongoing monitoring and maintenance of nexus review.

- Filing Returns
  - File Prospectively
  - Amnesty
  - Voluntary Disclosure Agreement
  
- Not filing returns
  - Statute of Limitations
  - Reserves/Financial Statement issues
  - Audit strategies
  - Litigation strategies

- Registration in the state
  - Can trigger questionnaires
- Consequences of Zero/Minimum returns

- What are amnesties?
- How are they different than Voluntary Disclosures?
  - Typically for a limited time period, sometimes for a limited number of taxes or tax issues.
  - Sometimes interest amounts are reduced.
  - Little to no negotiation.
  - Typically a statute enacted by the legislature.

## ■ The Basics

- Taxpayer agrees to pay tax and interest due for a limited look-back period (usually 3-4 years).
- Department agrees to waive penalties for the look-back period, and tax, interest and penalties for periods prior to the look-back period.
- Limited negotiability of terms
- Almost all states have some form of a voluntary disclosure program.
- The source of the Department's authority can vary.
  - In some states, specific statutes outline the program. In other states, there is a more general grant of authority to settle liability.



## ■ General Limitations and Constraints

- Not all taxpayers are eligible. The following taxpayers may not be allowed to participate in a state's program:
  - The taxpayer has been contacted by the Department
    - Contact does not mean the same thing in all states. Typically an audit, assessment, or criminal investigation disqualifies a taxpayer.
  - The taxpayer is already filing returns.
  - The taxpayer claims it has no liability for a tax at issue (but see advanced issues).
- A state's voluntary disclosure program may not include all tax types
  - (e.g., California withholding)

## ■ Advanced Issues

- What if the taxpayer does not think it owes any tax, but wants to ensure it will have no liability for earlier periods?
  - A taxpayer can attempt to negotiate with the Department. A taxpayer may leverage payment of one tax to close off liability for another tax.
- Can the taxpayer get the Department to agree to a specific position regarding an ambiguous statute or regulation?
- How much flexibility does the Department have in negotiating the deal?

## ■ Additional Issues

- What other types of registration are required as part of the Agreement?
  - E.g. registration with state secretary of state.
- Ongoing compliance responsibilities of the taxpayer
- Timing of future returns and request, i.e., what happens if the current period was not included in the look back period and returns are due?

- When should a company consider a VDA?
  - Nexus issues
  - Business did not inform the tax department of a change
  - Uncertain tax position has become material
  - Ignorance of the law
  - Impending sale of business

- A word about anonymity
  - Some (but not all) states allow a request to be made on an anonymous basis.
  - Important to keep anonymity as long as possible to ensure the taxpayer can withdraw.
  - At what point should the taxpayer's identity be disclosed?

## ■ MTC Program

- Most states currently participate in the program.
- Benefits of the MTC program
  - Allows many states to be addressed at once.
- Limitations
  - Very little contact with the Departments.
  - Limited flexibility in negotiating variations to the standard agreements.
  - Problematic for complicated issues.
- When should the MTC program be used?

## ■ Best Practices

- For multistate VDAs, it is important to keep track of all the moving pieces.
  - Status Chart
  - Regular calls with the taxpayer
- Timing
  - With respect to filing the requests, timing is of the essence
- Read Agreements carefully
  - Every state has differences regarding what has to be filed/completed

## ■ Best Practices

- In large multistate VDAs, there are lots of documents involved
  - Request, agreement, returns, miscellaneous forms, agreement
- Timing
  - When payments are due, make sure the taxpayer has ample time to prepare the returns, get the agreements signed, etc.
    - Pay particular attention to checks, may take some time for them to be issued
  - Make sure you have enough time to review the submission before it has to be sent in.
  - Most Departments are willing to extend deadlines, etc., but taxpayers need to make sure the extension is documented.



- Keeping it up to date
  - Who is responsible for maintaining the review?
  - How often should it be updated?
  - What resources are available?
    - Legislative monitoring services
    - Publications
    - Outside providers

## ■ Broader View

- Legislative efforts
  - State
  - Federal
- Coalitions and trade industry groups

## ■ Major events

- Mergers/Acquisitions
- Spin-offs