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Current Developments in State and Local Tax

Economic Nexus Expands to Income Tax

By Mary F. Bernard and Mark L. Nachbar



Since the 2018 U.S. Supreme Court decision in *Wayfair*,¹ the concept of economic nexus for sales tax purposes has expanded to all 50 states. Physical presence was deemed to be an unnecessary requirement to impose sales tax collection and remittance obligations. This ruling opened the flood gates to allow an unprecedented expansion of sales tax to businesses of all sizes and types, to include not only state-level sales taxes but local taxes as well.

Background

Now the concept of economic nexus is expanding to apply to some state income taxes. While physical presence was never a requirement to establish nexus for income tax purposes, when *Wayfair* overturned the longstanding *Quill*² decision, the requirement for physical presence to establish nexus for any tax went out the window. Although *Quill* was a sales tax case, the physical presence test had been informally applied in the income tax arena in some situations throughout the years. The *Quill* decision established the jurisdictional rule requiring “purposefully directed” economic activity, while removing any physical presence requirement for “minimum contacts” nexus under the Due Process Clause. An early attempt to assert nexus for income tax purposes without physical presence occurred in South Carolina in 1993 with the passage of *Geoffrey*.³ This case held that an out-of-state taxpayer was taxable on the in-state use of intangibles without any physical presence in the state. The U.S. Supreme Court declined to review this case as well as the subsequent nexus cases arising in approximately 14 other states. In addition to the states with economic nexus case law, states including New Hampshire, Oregon, and Wisconsin enacted statutes to assert income tax nexus when a taxpayer has a “substantial monetary presence” or “significant economic presence.” Even before *Quill* and *Geoffrey*, states like Indiana, Minnesota, Tennessee, and West Virginia asserted economic presence nexus over banks and financial entities.

The next major appearance of economic nexus arrived in 2006, with the *MBNA*⁴ case in West Virginia. Here, it was held that an out-of-state taxpayer was subject to income tax on transactions involving the issuance of credit cards to West Virginia residents, without the taxpayer having any physical presence in the state. This case was closely followed by cases involving other states asserting economic nexus on activities generating revenue through the licensing of intangibles.

Economic Nexus for Income Tax Before *Wayfair*

The precursor to the economic nexus standard, factor presence nexus, was alive and well in several states and continues with the advent of *Wayfair*. Alabama, Colorado, California, Connecticut, Michigan, New York, and Tennessee imposed economic nexus standards providing a bright-line test for income tax nexus. If a taxpayer's gross sales in the state exceed a certain threshold, the taxpayer would be subject to income tax in the state. Gross receipts states like Ohio and Washington adopted similar factor presence nexus standards.

The trend of economic nexus standards being imposed on out-of-state businesses with no physical presence is expected to continue.

In 2002, the Multistate Tax Commission (MTC) adopted a model statute that provides that income tax nexus is established if any of the following thresholds are exceeded:

- (1) \$50,000 in property in the state;
- (2) \$50,000 in payroll in the state;
- (3) \$500,000 in sales in the state; or
- (4) 25% of total property, total payroll, or total sales are in the state.

Several states and localities adopted these standards for income tax, gross receipts tax, or local taxes.

After *Wayfair*

In addition to the wave of sales tax law changes following *Wayfair*, states began to venture into income tax law changes, adopting economic nexus standards in a variety of ways.

Hawaii: In July 2019, Hawaii was the first state to impose economic nexus standards on business income earned by out-of-state businesses. Beginning with the 2020 tax year, it is assumed that a taxpayer with either 200 or more business transactions or gross income of \$100,000 or more in the state has established nexus, without any physical presence in the state.

Pennsylvania: In September 2019, Pennsylvania announced that a rebuttable presumption of corporate income tax nexus exists when a corporation has gross receipts of \$500,000 or more in the state, even without physical presence in the state. This threshold would apply beginning with the 2020 tax year.

Massachusetts: As validation for construing the state's tax jurisdiction to the fullest extent permitted by the U.S. Constitution and federal law, the state will presume that a general business corporation's virtual and economic contacts subject the corporation to the corporate income tax where the volume of the corporation's Massachusetts sales for the taxable year exceeds \$500,000. A general business corporation that is subject to the tax jurisdiction of the state because its activities are enumerated in the regulations may nonetheless be exempt from the income measure of the corporate excise, though not the non-income measure or minimum excise, by reason of the federal law, P.L. 86-272.⁵

Oregon: Effective for tax year 2020, Oregon's newly enacted Corporate Activity Tax (CAT) is imposed on taxable commercial activity within the state in excess of the bright-line threshold of \$1 million. Oregon's CAT is measured on a business's commercial activity—the total amount a business realizes from transactions and activity in the normal course of business in Oregon.

Texas: Gross receipts tax regulations were revised to adopt economic nexus standards for report year 2020. An out-of-state business without physical presence in the state will be presumed to have nexus for franchise tax purposes if it generates \$500,000 or more in Texas sourced receipts.

Washington: The Business and Occupation Tax law was amended to replace the factor presence nexus standard with economic nexus standards, requiring an out-of-state business with no physical presence to be subject to tax if

it has more than \$100,000 in cumulative gross receipts in the state in the current or in the immediately preceding year, effective for tax year 2020.

In addition to states adopting economic nexus standards, cities like San Francisco and Philadelphia have adopted threshold standards applicable to their gross receipts tax and business income and receipts tax, respectively. Economic nexus in San Francisco is established when a business generates more than \$500,000 of gross receipts in the city for the tax year. Amended its regulations to establish a nexus connection in the city when gross receipts equal at least \$100,000, with no physical presence required.

What About P.L. 86-272?

When P.L. 86-272 was passed in 1959, it was meant to be a temporary solution to protect interstate sellers from income taxation in states where their only business activity was solicitation of sales of tangible personal property. At that time, due to the nature of the manufacturing economy then, sales of services and intangibles seldom crossed state lines, foreign sales were rare, and digital products did not exist. When the law was passed, it was intended that Congress would determine a permanent solution to the treatment of interstate sales. Sixty some years later, the only legislative effort has surfaced in the Business Activity Tax Simplification Act resurrected a few times but never passed. The MTC has recently undertaken an attempt to revise its statement of information regarding P.L. 86-272 to incorporate business activities conducted through the internet.

The question arises, how does P.L. 86-272 interact with economic nexus standards imposing a tax liability on companies without physical presence? Economic nexus standards cannot override P.L. 86-272, but only regarding interstate sales—not foreign—and only regarding sales of tangible personal property—not services or intangibles. It should be noted that some states, specifically Illinois, Michigan, Montana, and Utah, have extended the

protections of P.L. 86-272 to include foreign commerce, but this is not the general rule. Also, of interest is the fact that P.L. 86-272 only applies to income taxes, not gross receipts, excise, or franchise taxes. The result is that economic nexus standards can only apply to those companies not protected by P.L. 86-272 based on the nature of their business activities within the state.

Just like the move to combined reporting and market-based sourcing, the states will attempt to remain competitive by adapting to the digital world of today in methods similar to their neighbors.

What's Ahead?

The trend of economic nexus standards being imposed on out-of-state businesses with no physical presence is expected to continue. Just like the move to combined reporting and market-based sourcing, the states will attempt to remain competitive by adapting to the digital world of today in methods similar to their neighbors. It would be concerning to taxpayers if any new economic nexus laws are imposed retroactively, requiring a complete review of the company's nexus positions under new laws. The nuances of ancillary activities under P.L. 86-272 become increasingly important to sellers of tangible personal property. It would follow that states will become more narrowly focused on interpretations under the federal law to investigate claims of protection from income tax. The revision to MTC's statement of information may provide some answers to remaining economic nexus questions.

ENDNOTES

¹ *South Dakota v. Wayfair, Inc.*, 138 Sct 2080 (2018).

² *Quill Corp. v. North Dakota*, 504 Sct 298 (1992).

³ *Geoffrey, Inc. v. South Carolina Tax Commission*, S.C. Supreme Court, 437 SE2d 13; cert. denied, 114 Sct 550.

⁴ *Tax Commissioner v. MBNA America Bank, N.A.*, WVA, 640 SE2d 226 (2006).

⁵ 15 USC 381-384.

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