

DOING BUSINESS ON THE WEB: STATE TAX TRAPS FOR THE UNWARY

Taxstringer
February 1, 2017

Originally published on the Taxstringer website. Reprinted with permission.

It isn't easy being an online retailer or service provider these days. Businesses have increasing opportunities and economic pressures to expand their market beyond a single state or region—in fact, other than “mom and pop” stores serving a single local community, it's rare to find any business that isn't seeking to expand its geographic market. And why not? All you need is a webpage and the ability to get your product or service to the customer. But with that expanded market comes an expanded footprint in multiple states, and therein lies the problem. With 50 states, 50 different taxing schemes, and even more local taxing jurisdictions, the compliance jungle can be overwhelming.

So what's a business to do? For most, limiting one's customers to a single jurisdiction is not an option. Thus, businesses need to be aware of the range of state tax obligations—not just sales taxes, but income taxes and employment taxes. As they say, the first step is acknowledging there's a problem. The second step is figuring out each state's rules, including which states might have filing obligations based on the company's business activities there. As discussed in more detail below, the central concept in the analysis is *nexus*—where does the company have enough of a connection to permit a state to tax it—or force it to be its sales collector—under the U.S. Constitution? The final step is to develop a plan to fix the identified problems while balancing risk and cost.

None of these steps is simple. This article is meant to offer a viable state tax compliance alternative to simply burying one's head in the sand. The one thing we know is that states are always looking for ways to increase tax revenues, and out-of-state businesses are often an easy target. Combine this incentive with states developing more sophisticated means of locating nonfilers, and the “do nothing” alternative becomes very risky.

What Activities Trigger State Tax Obligations?

As mentioned above, the guiding principal for whether a state gets to impose tax is nexus. Nexus is just a fancy word for “connection.” In order for a state to impose tax obligations on an out-of-state business, there must be a requisite level of connection

Attorneys

Joseph Endres
Elizabeth Pascal

Practices & Industries

State & Local Tax



DOING BUSINESS ON THE WEB: STATE TAX TRAPS FOR THE UNWARY

between the state and the business. Without getting too far into the constitutional weeds, the Supreme Court has held that for a state to impose tax, the Due Process and Commerce Clauses of the U.S. Constitution require “[s]ome definite link, some minimum connection between a state and the person, property, or transaction it seeks to tax.” (*Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–345 (1954).) Generally, the threshold is higher under the Commerce Clause, requiring “substantial nexus” to prevent a state from unduly burdening interstate commerce.

But how much of a connection is needed before a state can impose tax? The simple answer is: not much. For sales taxes, most states require some type of physical presence in the state before a business is required to act as an “agent of the state” and collect sales taxes from its customers on the state’s behalf, following the Supreme Court’s decision in *Quill v. North Dakota*, 504 U.S. 298 (1992). If you have an office in the state, or keep inventory there, it’s not surprising that the state would require you to register as a sales tax vendor. But even sending independent contractors or employees into the state a few times per year to meet with wholesale customers, take orders at a trade show, or provide maintenance can surpass the “substantial nexus” test.

Many states also permit “click through” and affiliate nexus, conferring sales tax nexus on an out-of-state seller based on the activities of third parties that benefit the seller. Although some states provide for de minimis activities that do not create sales tax nexus (e.g., attending a trade show without taking orders there), many states simply require any business to collect sales taxes from its customers if it is engaged in activities that would constitutionally permit the state to impose tax. As a general rule, if the company directly or through its agents is physically present in a state more than sporadically, it potentially has sales tax nexus. A few states are even questioning whether physical presence is still required. Alabama now requires sellers with more than \$250,000 in sales in the state to register as a vendor, and Tennessee has a similar requirement for sellers with “systematic solicitation” in the state and sales in excess of \$500,000. South Dakota only requires \$100,000 in sales or 200 separate transactions annually. At least 10 other states are considering similar legislation. With many states imposing individual liability on responsible persons for uncollected sales taxes, such economic nexus rules could have serious implications—not just for the business, but for individual owners or executives as well.

This “economic nexus” approach—imposing tax filing obligations on businesses with no physical presence in the state if they have sufficient in-state sales—is a much more widespread trend in the income tax arena, with a clear majority of states having economic nexus standards either through legislation or judicial decisions. Economic nexus legislation typically creates some bright line threshold called “factor presence.” California is a typical example: Businesses with more than \$50,000 in property, \$50,000 of payroll, or \$500,000 of sales in the state are required to file income tax returns. State courts that have held businesses to be liable for income taxes even with no physical presence typically rely on a standard of “purposeful activity in the state” reflected in the volume of in-state receipts. Only a few states’ courts have specifically ruled against using an economic nexus standard, including Alabama, Texas, and Montana.

The one caveat to the minimal threshold for a state to impose income tax is Public Law 86-272. Congress passed this law in 1959 to prevent a state from imposing income tax obligations on a business if its only activities in the state are soliciting sales of tangible property. But beware of the very limited application of this law: It only applies to sales of tangible property, not sales of services or digital property. It only applies to net income taxes and not gross receipts taxes, such as the Ohio Commercial Activity Tax or the Texas Margin Tax. And it only protects activities that are narrowly defined as solicitation of sales or ancillary to solicitation; anything viewed as beyond the scope of solicitation—repairs, collection activities,

DOING BUSINESS ON THE WEB: STATE TAX TRAPS FOR THE UNWARY

management of customer complaints—is no longer protected. Moreover, states can still subject a business to a filing obligation and payment of minimum taxes under an alternative tax base (e.g. Georgia’s “net-worth” tax or Massachusetts excise base tax).

What About Employees?

A business also needs to be cognizant of employer withholding obligations. Many web-based businesses permit their employees to work from their home, which can create a number of different tax obligations for the business. First, the business likely has to withhold taxes in the employee’s state of residence and work. While this may not be particularly burdensome, it can translate into nexus for other state tax obligations. Some states—such as New Jersey, Illinois, and Ohio—have determined that the presence of a telecommuter is a sufficient connection to require the business to file income tax returns. Permitting telecommuting as a cost-saving measure may therefore have much wider financial implications. Second, a handful of states—New York, Pennsylvania, Delaware, New Jersey, and Nebraska—have a so-called “convenience rule”: If the business is located in New York, for example, and the employee is based out of or reports to that office, the state treats the employee as if they are physically working in that office for withholding tax (and personal income tax) purposes, even if they are actually working from a home office in Connecticut. Thus, New York would require the business to withhold New York taxes from that employee. Unfortunately, Connecticut could also treat those same wages as subject to Connecticut withholding.

Traveling employees present even more of a state tax burden. Many states, such as South Carolina and Arizona, require a business to begin withholding personal income taxes on the employee’s wages on the first day of business travel into that state. Other states require withholding after the employee spends a certain number of days (e.g., 14 for New York or Connecticut) or earns a certain amount of wages (e.g., \$1,000 in Idaho or above the low-income exemption amount in California) in the state during the year. So a Virginia-based web designer that sends a Virginia-based employee to meet with customers in 12 different states during the year might have to withhold taxes in 13 different states if the threshold is exceeded. And again, sending that employee to meet with customers might not only give rise to a withholding obligation, but could subject the company to income and sales tax obligations in some—or all—of those states.

What’s a Business to do?

Just hoping that states won’t initiate nexus inquiries has become a high-risk strategy. States are looking for new sources of revenue, and out-of-state companies offer a vast well of opportunity. With no prior filings, there is also no statute of limitations running to limit the potential exposure. But simply registering in 50 states for income, sales, and withholding taxes is also not a viable option for most companies. Instead, a company should evaluate its exposure across states and focus on taking action where that exposure is highest. Take Company X with its sole office in Ohio. It sells widgets over the internet across the United States, but most of its customers are on the east coast. It has five employees that travel throughout the east coast, meeting with wholesale customers and attending trade shows.

After reviewing its activities and volume of sales across the east coast, the company determines that four states present the highest potential tax exposure. Three other states have some risk, and the company expects to grow its market in those states. In the remaining states, the company either has limited presence that would create nexus or its sales are low, creating

DOING BUSINESS ON THE WEB: STATE TAX TRAPS FOR THE UNWARY

limited exposure.

Based on this analysis, the company can now create a state tax compliance plan going forward. In the high-risk states, the company can look at options for voluntary disclosure or amnesty to resolve any exposure for past periods. The Multistate Tax Commission offers “one-stop shopping” to resolve tax liabilities in multiple states. In the lower-risk states, the company might consider a similar strategy or decide to register and file going forward. In the remaining states, the company might just adopt a “wait and see” strategy, given the low amount of potential exposure.

A state tax compliance plan is a necessary but often neglected part of business development for web-based companies. Without it, a company may run afoul of multiple taxing jurisdictions without even realizing that its presence has moved beyond the internet. State revenue authorities are getting more sophisticated and aggressive every day. Businesses that fail to recognize and address these issues do so at their peril.