Nexus Guidelines

Berntson Porter
& COMPANY PLLC
Certified Public Accountants & Consultants

11100 NE 8th St, Suite 400 ▪ Bellevue, WA 98004
www.bpcpa.com ▪ (425) 454-7990

Nexus, States know it when they see it…

Nexus is the minimum connection a business must have with a state before that state can require the business to file and pay taxes. Understanding where a business has created nexus is important because without nexus, there is no tax filing obligation.

Conversely, if a business has nexus and is not filing returns, the state can generally assess taxes, penalties and interest for several years, potentially back to when nexus was first created. Once a business begins filing returns in a state, the statute of limitations begins to run on the years open for audit. In most states, the periods open for audit are the 3-5 prior years if returns were filed.

As an example, consider a business which has made $100,000 in annual sales for the past 5 years in a state with a 10% sales tax rate. If that business has not been filing and has nexus, they could be assessed $50,000 in sales tax plus penalties and interest on audit. With no nexus, there would be no tax due. So understanding where nexus has been created and the potential exposure is key for managing business risks.

States interpret nexus differently for income/franchise taxes and sales taxes. While each state makes these determinations separately based on their particular state laws and court cases, there are some general guidelines due to federal laws and cases. These guidelines are briefly summarized below, along with issues to be aware of when a company engages in business activity and has customers in multiple states.

Sales Taxes

Prior to 2018, due to US Supreme Court cases (the most prominent being Quill vs North Dakota), a physical presence in some form was required to create nexus. While an office location or employees certainly are a sufficient (and visible) way to create nexus, with the expansion of e-commerce states have taken more aggressive interpretations of the traditional physical presence criteria to counter the related erosion of their tax base.

Resident employees, inventory and property in a state create nexus. Additionally, transient activities (employee visits to customers, including trade shows) and third parties acting on behalf of the business (sales representatives) can similarly trigger nexus as they are furthering the company's ability to do business in that state. Nexus has even been attributed due to website links (click-thru nexus) or cookies on resident's computers or phones in some states.

However, the recent US Supreme Court Wayfair v South Dakota decision overturned this protection, and now out of state businesses are no longer required to have a physical presence in a state to create nexus. This decision found that a physical presence is not required to create nexus, and opened the door for nexus creation due to a business' economic activity in the state.

At issue in the Wayfair decision, was whether South Dakota's law asserting that businesses with sales of $100,000 or 200 transactions in South Dakota were required to collect and remit the state's sales tax.

The law was designed to fast track a case to the US Supreme Court with the hope that the physical presence requirement would be overturned. The court complied, and the physical presence requirement from Quill was overturned.

In response, nearly all states have adopted similar economic nexus thresholds in the past two years. So now there are two main ways that states are asserting nexus 1) physical presence or 2) economic nexus thresholds.

Prior to Wayfair, a business had some measure of control over which states it created nexus in based on decisions around locations, employees, inventory and sales activities. With the overturn of Quill and the physical presence requirement, a business' customers now determine where it has nexus.

Income and Franchise taxes

Similar to sales taxes, a physical presence can create income or franchise tax nexus. Also like sales taxes, some states have adopted economic nexus thresholds as well.

Economic nexus concepts have existed for income taxes longer than for sales taxes (the Quill case involved sales taxes), however not as many states have formally adopted these as compared to sales taxes. States with economic nexus thresholds for income/franchise taxes range from $100,000 - $500,000 with a few states even higher. However, others are more vague on when a business has an economic presence, leaving it open to interpretation.

Some states may also require income tax filing if the company is authorized to do business in the state with the Secretary of State or other agency, regardless of revenues. Finally some state licensing requirements (such as for liquor or wine shipping) or customer contract requirements (such as contracts with state or local governments) also require registration and filing (for sales and/or income taxes).

Another complexity with income taxes (and to a lesser extent sales taxes) is determining the amount of sales in each state. There are different rules depending on whether your company sells products, services, and in some cases who your customers are (such as Government sales). However there may also be some limited protection from income taxes due to Public Law 86-272, but this is a detailed analysis beyond the scope of this article.

In Summary

Nexus is an area of frequent disagreement between businesses and taxing authorities, and many areas are still unresolved. For example, if $100,000 in sales is sufficient to create sales tax nexus is it also sufficient to create income tax nexus? Will filing sales tax returns in a state without filing income taxes become an audit red flag? Do employees working from home during the pandemic create nexus for their employers?

Determining whether nexus exists is only the first step in determining whether a company should register or begin filing in a state. For example, states differ on what products and services are subject to sales tax, so sales may not be taxable in all states. Similarly, states have various sales tax exemptions that may apply to different types of sales or when put to various use (such as for resale).

We can help you understand your businesses nexus profile, potential tax risk, and options to mitigate or reduce this risk. There is no one-size-fits-all solution, but there are options depending on your unique facts and circumstances. Addressing this risk proactively can not only save your company from needless penalties and interest, but will also make your business more resilient in uncertain times.