

How COVID-19 Is Forcing States and Taxpayers to Re-Sweep the Minefield

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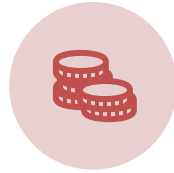
Agenda



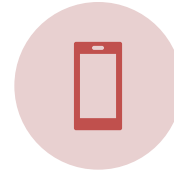
NEXUS
TIMELINE



SALES TAX
NEXUS



INCOME TAX
NEXUS

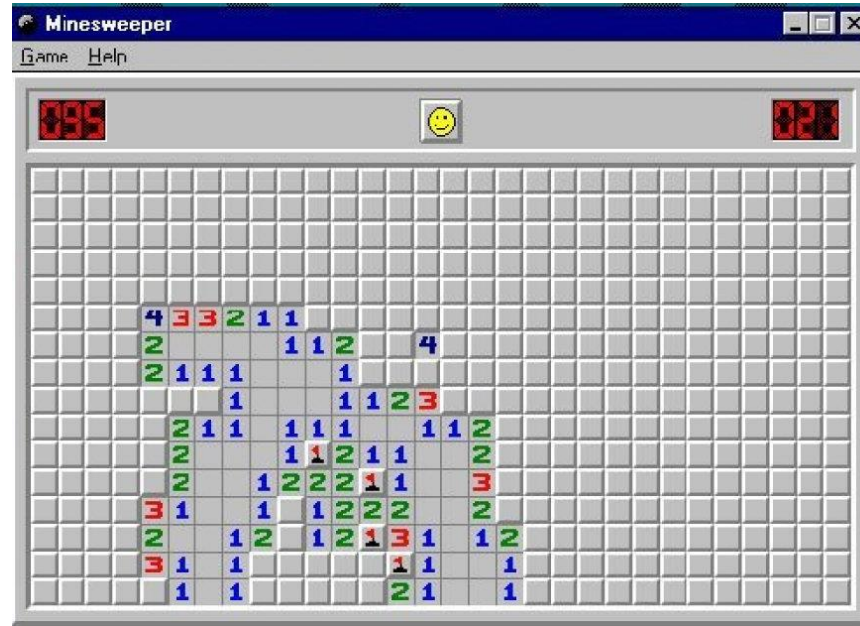


MOBILE
WORKFORCE



NEXUS
AUDITS

Polling Question!



How Did We Get Here?

Seven Decades in Seven Minutes



Limitations on States' Ability to Impose Tax

- State Law
- Federal Law
 - Public Law 86-272
- U.S. Constitution
 - Due Process Clause
 - Commerce Clause

Nexus Timeline

- 1959: Public Law 86-272
- 1967: *National Bellas Hess*
- 1992: *Quill*
- 2000: Congress's Advisory Committee on Electronic Commerce
- 2005: Streamlined Sales and Use Tax Agreement
- 2018: *Wayfair*
- 2020: COVID

National Bellas Hess (1967)

- Out-of-state mail order company
- No physical presence in state
- **Held:** Imposing use tax collection obligations on a seller with no physical presence in the state is unconstitutional in violation of the Due Process and Commerce Clauses.
- Concerned about 2,300 taxing jurisdictions

Quill (1992)

- Mail-order seller; no physical presence in state
- Upheld the *National Bellas Hess* physical presence rule under Commerce Clause only
 - Due Process Clause: minimum contacts, purposeful availment, rational relationship between interstate activity and taxing state
 - Commerce Clause: substantial nexus = physical presence
- “Structural concerns about the effects of state regulation on the national economy.”
 - Number of taxing jurisdictions grew to 6,000;
 - “Continuing value” in a “bright-line” rule;
 - Upheld in part because of *stare decisis*; and
 - “Congress has the ultimate power to resolve.”

States' Nexus Efforts

- Strict enforcement of physical presence
- Agency or affiliate nexus
- Click-through nexus
- Marketplace provider nexus
- Cookie nexus
- Use tax notice and reporting

Wayfair (2018)

- 6/21/2018 – U.S. Supreme Court in a 5-4 decision overrules *Quill* and *National Bellas Hess*
- Held: The physical presence rule is:
 - unsound,
 - an incorrect interpretation of the Commerce Clause, and
 - restricts the states’ authority to “collect taxes and perform critical public functions.”
- Favorable comments about the ease of administering South Dakota’s provisions:
 - 1) Requires “considerable amount of business” in South Dakota (referring to the \$100,000 or 200 transactions thresholds, a bright-line standard)
 - 2) Law is not retroactive
 - 3) South Dakota is a party to the Streamlined Sales Tax Agreement

“Virtual Connection”

“A virtual showroom can show far more inventory, in far more detail, and with greater opportunities for consumer and seller interaction than might be possible for local stores. Yet the continuous and pervasive virtual presence of retailers today is, under *Quill*, simply irrelevant. This Court should not maintain a rule that ignores these substantial virtual connections to the State.”

Polling Question!

Sales Tax Nexus

States React to Wayfair

- Variety of Economic Nexus Thresholds
 - \$500,000 and 100 transactions
 - \$500,000
 - \$300,000 and 100 transactions
 - \$250,000 or 200 transactions
 - \$100,000 or 200 transactions (most common threshold)
- Several states have eliminated the number of transactions threshold; trend will likely continue

Threshold Issues

- Costs may exceed benefits
 - 200 transactions x \$5 average transaction = \$1,000 in sales and ~\$75 in annual tax due
 - Cost of compliance (taxpayer) and processing/review (taxing authority) may significantly outweigh the economic benefit (taxes paid) to each state
 - States are moving away from transaction thresholds
- Lack of uniformity
 - Gross Revenues
 - Retail Sales (i.e., not “Wholesale Sales”)
 - Taxable Sales
 - Exempt Sales; Non-Taxable Sales; Occasional/Bulk Sales
- When must compliance begin?
- What about taxes imposed and administered by localities?
- Software solution challenges

Marketplace Provisions

- Majority of states have adopted laws requiring online marketplaces to either
 - collect and remit taxes on sales made into the state through the marketplace, or
 - report those sales to the state and notify customers that they could owe tax on their purchases
- Different definitions of “marketplace provider”
 - Narrow definitions: limit to include persons handling customer’s payment.
 - Broad definitions: do not have same limitation
 - Some states refer to and treat marketplace providers as “retailers”
- Variety of thresholds
 - At marketplace level
 - At retailer level
- MTC: Annual White Papers (2018-2020)
 - Economic nexus thresholds should include facilitated and direct sales
 - Audit risk falls on marketplace provider/facilitator unless erroneous product information is provided by marketplace seller

Impact of COVID-19

- People are working differently
 - *Quill* standard
 - *Wayfair* standard
- State responses
 - Generally, no *Quill* nexus...for now
 - No impact on *Wayfair* nexus
- Decrease in audit activity
 - Lower revenue
 - Bored auditors
 - Nexus Questionnaires
- Increased focus on sales tax as a result of CARES Act

Income Tax Nexus

Overview

- Most states have had economic nexus for income tax purposes for decades
- Litigation around the country upheld income tax economic nexus provisions
 - e.g., *Geoffrey v. South Carolina* (royalty license with affiliate)
 - U.S. Supreme Court never addressed the issue
- Taxpayers nonetheless took “physical presence” filing positions based on *Quill*
- *Wayfair* held that *Quill* was and always has been wrong



Factor Presence – 2002 MTC Nexus Standards

- Substantial nexus established for business activity tax purposes for...
 - Resident individuals
 - Business entities that are organized or commercially domiciled in the state
 - Nonresident individuals and business entities organized outside the state have substantial nexus if they exceed thresholds

MTC Factor Presence Nexus Standards: Thresholds

- Thresholds:
 - \$50,000 property; or
 - \$50,000 payroll; or
 - \$500,000 sales; or
 - 25% of total property, total payroll, or total sales
- Thresholds adjust for inflation based on consumer price index

Factor Presence

- Many states had enacted MTC factor presence standards before *Wayfair* (pre-2018): e.g., AL, CA, CO, MI, TN
- Other pre-2018 factor presence standards:
 - CT: active solicitation and “significant” receipts (\$500,000 or more per year)
 - MT: active solicitation and receipts of \$350,000 or more per year
 - NY: \$1,000,000 or more in receipts

Factor Presence Standards Enacted After *Wayfair*

- San Francisco: annual gross receipts within the city over \$500,000
- Massachusetts: \$500,000 in sales
- Philadelphia: \$100,000 in Philadelphia sourced gross receipts during any 12-month period
- Pennsylvania: \$500,000 in sales creates a rebuttable presumption
- Texas: \$500,000 in annual Texas gross receipts
- Oregon: \$750,000 in sales
- Hawaii: sales tax standards (200 or more transactions or gross Hawaii source income of greater than \$100,000)

Economic Nexus Without Factors: Minnesota Example

- Physical presence in Minnesota OR
- Economic nexus: obtain or regularly solicit business in Minnesota without regard to physical presence
 - Presumed to be obtaining or regularly soliciting business if transactions with 20 or more persons within Minnesota during any tax period

PL 86-272 (1959)

- *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959)
 - U.S. Supreme Court affirmed Minnesota’s imposition of income tax on an Iowa cement company
 - Only activities were solicitation of orders for the sale of products; each order was accepted, filed, and delivered from Iowa.
- Public Law 86-272 passed 9 months after *Nw. States Portland Cement* as a “temporary measure pending a deeper review of state taxation.”
 - Safe harbor from income tax
- When a federal statute and a state statute (e.g., P.L. 86-272) are in conflict, the federal law preempts the state law pursuant to the Supremacy Clause of the U.S. Constitution

Elements of PL 86-272

- Applies only to net income taxes
- The only protected “business activity” in the state is the solicitation of orders for sales of tangible personal property
- The orders solicited in the state must be
 - sent outside the state for approval
 - filled by shipment from delivery outside the state

15 U.S.C. § 381(a)

Wrigley (1992)



- U.S. Supreme Court interprets PL 86-272
- William Wrigley, Jr., Co. – “world’s largest manufacturer of chewing gum”
- Clarified that “solicitation” activity includes “ancillary activities”
 - Serve no independent business function apart from soliciting of orders
 - Examples: in-state recruitment, training, and evaluation of sales representatives; use of hotels and homes for sales-related meetings
- “De minimis” non-solicitation activities permitted
 - Cannot establish a nontrivial additional connection
 - Cannot be activities that constitute a “matter of regular company policy” conducted on a “continuing basis”
 - Not measured by importance or by dollar impact

Kirby Vacuum: Minnesota Case

- Scott Fetzer Co. (“Kirby”) sold vacuum cleaner systems through network of independent distributors
- Distributors order vacuums from Ohio
- Products are shipped to distributors by common carrier from outside Minnesota
- Distributors contract with independent dealers to sell the vacuums
- Distributors provide “service” to all users of Kirby Systems, including repair service, in accordance with three-year limited warranty.
 - Includes replacement of defective parts through an authorized Kirby distributor.



Kirby Vacuum: Minnesota Case

- Held: Warranty repairs could be ancillary or *de minimis* – additional facts were needed.

MTC PL 86-272

Statement of Information

1986 (updated 2001): lists various protected and unprotected activities

2018-2020 Work Group:

- Initiated 11/7/2018
- 12 states
- Purpose: Evaluate how PL 86-272 applies to “modern business activities” post-*Wayfair*.

MTC PL 86-272

Statement of Information

- “Activities Conducted Via The Internet”
 - “As a general rule, when a business interacts with a customer via the business's website or app, the business engages in a business activity within the customer's state.”
 - “However, for purposes of this Statement, when a business presents static text or photos on its website, that presentation does not in itself constitute a business activity within those states where the business's customers are located.”
- Virtual Presence: Members found relevant the *Wayfair* Court's observation that an Internet seller “may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term.”

MTC PL 86-272

Statement of Information

- 11 Factual Scenarios Considered
- Scenarios that do not defeat PL 86-272 immunity
 - Basic website offering TPP for sale
 - Static FAQs on website
 - Internet “cookies” placed on computers of in-state customers that gather information for purposes of solicitation only

MTC PL 86-272

Statement of Information

- Scenarios that do defeat PL 86-272 immunity
 - Post-sale assistance via electronic chat or website email
 - Credit card solicitations via website
 - Employment applications via website
 - Internet “cookies” placed on computers of in-state customers that gather information for purposes of adjusting production schedules, inventory, new product development, identifying new items for sale
 - Product fixes and upgrades that transmit code or other electronic instructions via the Internet
 - Offering warranty plans for sale on website
 - Contracting with a marketplace facilitator who maintains inventory at fulfillment centers
 - Streaming videos and music to electronic devices for a charge (streaming is not TPP)

MTC PL 86-272

Statement of Information

- Newly “unprotected activities” include the following:
 - Regularly providing post-sales assistance to in-state customers via either electronic chat or email;
 - Soliciting and receiving on-line applications for branded credit card via the business's website;
 - Inviting viewers in a customer's state to apply for non-sales positions with the business via its website;
 - Placing internet “cookies” onto the computers or other devices of in-state customers and the cookies gather customer search information that will identify new items to offer for sale; and
 - Offering and selling extended warranty plans via website to in-state customers.

MTC PL 86-272

Statement of Information

- August 5 Public Hearing held (90 participants)
- Comment Period Open until September 4 (several comments have already been submitted)
 - Massachusetts supports statement, citing its “cookie nexus” regulation
 - Comments in opposition:
 - COST opposing: if the newly proposed list of unprotected activities is adopted, “P.L. 86-272’s protections will be effectively eviscerated.”
 - Contrary to Congress’s intent in enacting PL 86-272
 - Neither MTC nor states have authority to narrow PL 86-272

Due Process Clause

- Concerned with fundamental fairness
- A state may not impose income tax on “value earned outside its borders.” *Container Corp.* (1983)
- Test:
 - Minimum connection between the interstate activities and the taxing state, and
 - Rational relationship between the income attributed to the state and the interstate values of the enterprise
- A state must have a connection with
 - The activity it seeks to tax and
 - The taxpayer generally
- Taxpayer need not be physically present; can be satisfied by economic activity
- Due Process Clause becoming more relevant post-*Wayfair*

Fielding (Minn. 2017)

- Fiduciary income tax case
- Held: Minnesota could not tax 100% of the income of a trust based solely on the fact that the grantor was a Minnesota domiciliary at the time the trust became irrevocable
 - Nexus is a year-by-year analysis
 - Historical connections to Minnesota irrelevant

Greenscapes Home & Garden Prods. (Ohio, February 7, 2019)

- Greenscapes was a Georgia company selling garden products to national retailers with distribution centers in Ohio.
 - Customers provided shipping with pickup from Greenscapes' loading dock with title transfer in Georgia.
 - Greenscapes could not track the final destination of the products.
- Held: Greenscapes had sufficient Due Process nexus with Ohio for Ohio's commercial-activity tax ("CAT") because it knew its customers were bringing its products into Ohio.
 - "A defendant who sells products to a national or regional retailer for the resale to ordinary, individual customers in the forum state has purposefully availed itself of the privilege of doing business in the forum state."

Polling Question!

Mobile Workforce



The Minnesota Society of CPAs (MNCPA) is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: www.NASBARegistry.org

Nexus Implications

- Physical presence
- Factor presence
- *Telebright Corp.* (N.J. 2012)
 - One employee who telecommuted full-time from her New Jersey residence writing software code created nexus for the out-of-state software development company.

Withholding

Which states are the most friendly to mobile workers and their employers?

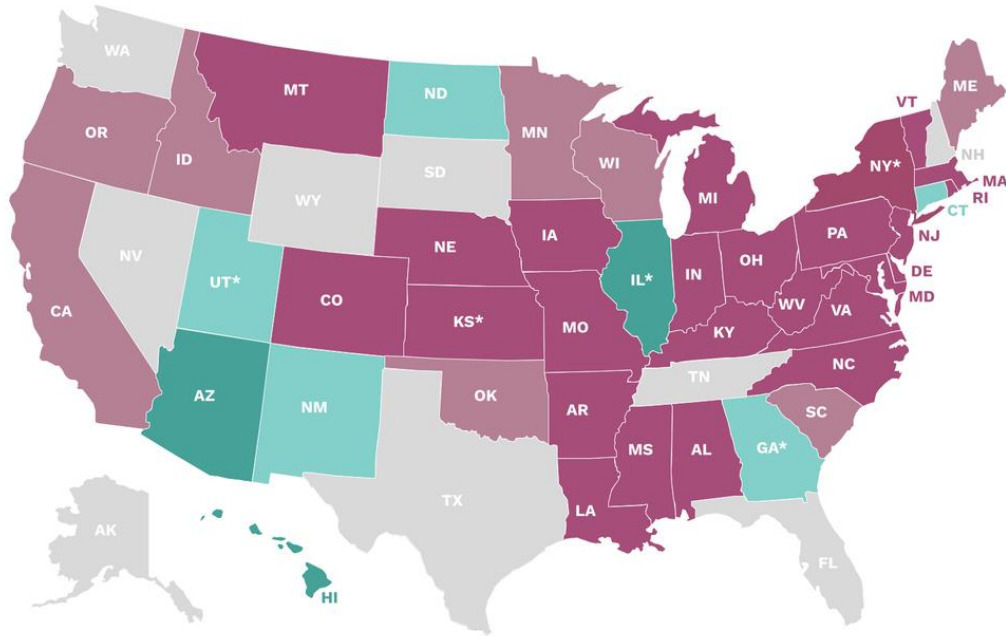
Very Friendly. State allows employees to work within the state for 30 or more days before employer is subject to withholding (AZ, HI, IL).

Moderately Friendly. State allows employees to work in the state between 15 and 29 days before employer is subject to withholding (CT, GA*, NM, ND), or has other accommodating provisions (UT*).

Unfriendly. State only allows employees to work in the state between 2 and 14 days before employer is subject to withholding (ME), or has a wage-based threshold (CA, ID, MN, OK, OR, WI).

Very Unfriendly. State requires employer withholding on first day an employee works within the state (24 states), or requires an individual to file on first day even if employer isn't required to withhold on first day (NY).

Not applicable. No state income tax.



Notes: In Georgia, employer must withhold if the employee is in the state for more than 23 days in a calendar year, or if \$5,000 or more or 5% or more of total income is attributable to Georgia. In Illinois, the 30-day threshold applies for tax years beginning after December 31, 2020 (this is the result of legislation enacted in 2019). In Utah, employer must withhold if the employer (not the employee) does business in the state for more than 60 days in a calendar year. *Kansas considered 30-day legislation in 2020.

Source: mobileworkforcecoalition.org/problem

Mobile Workforce: State Income Tax Simplification Act

- Creates a bright-line 30-day threshold before State employer withholding and personal income tax liability would apply
- Exceptions for entertainers, athletes, prominent public figures and certain production employees

Telecommuting During COVID

- Nexus waivers
 - Minnesota Department of Revenue issued guidance that it will not assert nexus for business income tax purposes "solely because an employee is temporarily working from home due to the COVID-19 pandemic." (COVID-19 FAQs for Businesses, Minnesota Department of Revenue, 05/05/2020.)
 - Some states are not waiving nexus (e.g. Alaska, Michigan)
 - Some states have issued no guidance (e.g. California)
- Expiration dates?
 - Massachusetts and Oregon have set 2020 end dates for their COVID-19 telecommuting nexus waivers

Telecommuting During COVID

- Withholding and individual income tax implications do not match nexus waivers
- Massachusetts:
 - Nonresidents who worked in the state but are now working remotely because of the Massachusetts state of emergency, medical guidance, or work policy related to COVID-19 will continue to pay Massachusetts state income taxes
 - Residents who usually work in other states, but are now working remotely from Massachusetts, will be eligible for a credit for taxes paid to that other state
 - Effective 7/21 and will expire either 12/31/2020 or 90 days after state of emergency is no longer in force
- New York, Vermont, and others are continuing to tax telecommuting nonresidents working within their states

Nexus Audits



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Pre-Audit Compliance Strategies

- Evaluate nexus in each state
 - Sales (# and \$)
 - Physical presence
- Determine impact of nexus on all tax types
- Evaluate software compliance options
- Consider voluntary disclosure

Nexus Audit Triggers

- 1099 Audits
- Filing returns for one type of tax but not another (e.g. withholding, but not sales or income)
- Filing PL 86-272 returns

Lifecycle of a Nexus Audit

- Nexus Questionnaire
- Information and Document Requests
- Demand for Returns
- Appeals

Polling Question!

Questions?



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