

Multi-State Taxation - What is Your Risk?

Although the issue is often overlooked, multi-state taxation may be a major concern for manufacturing operations. If you do business in other states, whether via the internet or otherwise, you will likely be affected. At the heart of the debate is nexus. The nexus requirement is a fundamental principle contained in the Due Process and Commerce Clauses of the United States Constitution.

Essentially, these clauses require that there must be a definite link or some minimum connection between the state and the person, property or transaction it is seeking to tax. This rule of law is based on the proposition that a particular state has jurisdiction to tax people over whom it confers “protection, opportunities and benefits.” The nexus requirement must be satisfied under both clauses for a state to exert its taxing authority over an out-of-state seller.

Due Process Clause: A string of cases has established that is not necessary for a taxpayer to be physically present in the state in order for the state to constitutionally assert jurisdiction over a taxpayer under the Due Process Clause. For instance, soliciting customers through the mail or other means is sufficient to create a nexus. It is only required that the taxpayer “purposely avail itself of the benefits of economic market” in the state, regardless of any physical presence.

On the other hand, it is noteworthy that the Due Process Clause may, in fact, preclude a state from asserting jurisdiction over a taxpayer even if it maintains a physical presence in the state. This could occur when the presence is inadvertent (e.g., the property is under the control of another entity).

Commerce Clause: The Commerce Clause is primarily directed at national economic unity and the effects of state regulation on the country’s economy. Earlier landmark court decisions created a “bright-line test” of physical presence. However, recent cases have signaled a retreat from this stringent test in favor of a more substantive approach.

For manufacturing concerns and other entities unclear of their status under the Due Process and Commerce Clauses, a properly conducted “nexus study” can identify the normal business activities in relation to the nexus standards relied upon by the various states. If nexus is found to exist and the taxpayer has not been filing tax returns, enrollment in a voluntary disclosure program may be initiated.

As with most other business aspects, the management team of a manufacturing operation has some degree of



control over activities creating nexus. If the objective is to avoid tax nexus for a particular state, certain activities may have to be curtailed or even eliminated to reduce nexus risk.

In a case where the activities creating nexus simply cannot be avoided, but the tax is unreasonably high, it may be advantageous to restructure the business operations to isolate the nexus activities.

It is difficult to control use tax nexus in a particular state, although the tax may be passed on to customers. Sellers generally retain liability for any tax collected from customers unless proper documentation of a valid exemption has been obtained. Satisfying this documentation requirement generally cannot be accomplished after the fact.

Advances in technology have also made states more resourceful in ensuring that sales or use tax has been properly collected and that state nexus has been established when it is warranted.

It is recommended that taxpayers have state nexus issues analyzed and a study conducted when it is appropriate for the situation.

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