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5 Things to Understand About Your Nexus Footprint

A **YETTER** and **Sales Tax Institute** White Paper

READ THIS PAPER TO UNDERSTAND:

- What nexus is and how it can impact you
- How to determine if you have any nexus exposure
- How to monitor your business for nexus
- How to deal with nexus issues
- How to minimize the impact of nexus

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INTRODUCTION

Nexus, Latin for a connection or common link, was never meant to be a threatening word. But for businesses today, the threat of creating sales tax nexus within a taxing jurisdiction has given the word a new and highly negative connotation. Small- to mid-sized and fast-growing companies in particular are in a double bind regarding sales tax nexus: they're sizable and busy enough to find themselves in the increasingly broad sights of local tax officials, but they typically lack the expertise and means to minimize their tax liability and audit exposure.

The complexities and fluidity of nexus coupled with the taxability challenges of what is sold can be overwhelming and require the constant attention of a tax expert to navigate, but most small- to mid-sized businesses cannot afford that kind of resource internally. Meanwhile, the penalties of undercollecting, underreporting and underpaying can be huge—and there's rarely a statute of limitations, meaning states can go back for years to collect what's due if they discover you haven't properly met your sales and use tax obligations.

If it is determined that you should have collected the tax from your customer, but you failed to, then you just reduced your profit margin. Sales taxes should not be a direct cost to a seller—rather sellers should act as an agent for the state. But, if you didn't collect the tax, the state can hold the seller liable in most cases. So, if you didn't collect the tax from your customer, you just increased your cost by the tax that you should have collected. Can your business absorb the impact of an average tax rate of almost 10 percent? Even though sellers have the option to try to collect the tax due from their customers, this isn't always successful—what if they are no longer a customer, out of business or just refuse to pay you years after the transaction occurred? Then there goes your profit. And that is just the tax amount. Add to this penalties and interest. Even if you survive an audit unscathed, the process itself can be a significant time and resource drain.

Small- to mid-sized and fast-growing companies in particular are in a double bind regarding sales tax nexus: they're sizable and busy enough to find themselves in the increasingly broad sights of local tax officials, but they typically lack the expertise and means to minimize their tax liability and audit exposure.

Revenue-hungry states are becoming increasingly aggressive in attempting to catch transgressors. But forewarned is forearmed. To help you reduce your exposure, this paper examines the significance and the vagaries of sales tax nexus. It discusses the activities that create nexus, what having nexus requires you to do, the key mistakes to avoid when completing a state nexus questionnaire, and how to deal with problems you may discover. It concludes with our recommended course of action for dealing with sales tax nexus issues.

I. WHAT IS NEXUS … AND HOW CAN IT IMPACT YOU?

Sales tax nexus defines the level of connection between a taxing jurisdiction such as a state and an entity such as your business. Until this connection is established, the taxing jurisdiction cannot impose its sales taxes on you. Nexus determination is primarily controlled by the U.S. Constitution, in which the Due Process Clause requires a definite link or minimal connection between a state and the entity it wants to tax and the Commerce Clause requires substantial physical presence. Unfortunately, these concepts are over 200 years old, and business today is much different than in colonial times (Pony Express vs. Snapchat!). After that, nexus gets foggy and complex and is left up to the states to define within the constraints of these provisions. U.S. Supreme Court decisions help interpret the state laws—but the last time the Supreme Court heard a case on sales tax nexus was in 1992—and it didn't consider internet activities in that decision.

There is no specific shared definition of nexus across the 50 states. Moreover, definitions and rules for determining nexus change constantly, and most states are careful to give themselves room to maneuver in their definitions. This means that a business must look at each state individually when determining sales tax nexus, and must stay constantly on top of a slew of changing regulations and interpretations.

Here are two representative definitions of Nexus that most states would more or less agree with. As you read them, you can almost feel the steel jaws starting to clamp around you:

- "Maintaining, occupying, or using permanently or temporarily, directly or indirectly or through a subsidiary, an office, place of distribution, sales or sample room or place, warehouse or storage place or other place of business."
- "Having a representative, agent, salesman, canvasser, or solicitor operating in this state under the authority of the retailer or its subsidiary on a temporary or permanent basis."

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These definitions—which focus around having a business presence in a state—are just starting points for determining nexus. As we'll discuss, there are innumerable details, timescales, vagaries and state-by-state idiosyncrasies involved. But the point is, if you have knowingly or unknowingly created nexus in a state, then you are subject to some very strict obligations.

IMPLICATIONS OF NEXUS: WHAT ARE YOUR OBLIGATIONS?

If you have created nexus within a state or other jurisdiction, you are obliged to register as a retailer and collect and remit sales tax on all taxable sales into that jurisdiction. You are also obliged to obtain exemption certificates on all tax exempt sales into the jurisdiction.

Nexus is also relevant to purchasers. If you have nexus in a jurisdiction and the seller didn't collect tax, you are also required to remit use tax on taxable purchases delivered within that jurisdiction. This includes taxable advertising and promotional items (trade show giveaways, in-store handouts, etc.) that you might distribute in the jurisdiction.

As you might suspect, it is incumbent on you to accomplish all of the above in a timely and accurate fashion. Even when you do it all correctly, you are still potentially subject to audits by the jurisdiction.

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NEXUS ENFORCEMENT: STRONG ARM OF THE LAW

As federal funding to states has diminished, states have become much more aggressive in identifying and collecting all the tax revenue they can. They are looking harder for transgressors, hiring more tax auditors and sending their auditors out more frequently. They are also relying on upgraded internal systems that allow them to compare registrations across tax types and even check registrations against companies that have contracts with the state or its agencies.

Here are some of the tools and tactics that states use to determine who to pursue and audit:

- Nexus questionnaires are among a state's primary enforcement tools. States periodically send out mass mailings indicating that the receiving company may be subject to reporting and collecting sales tax in the state. These mailings typically include nexus questionnaires that must be completed and returned promptly.

- Ignoring these questionnaires is not an option because doing so can eliminate potential settlement options down the road. Nexus questionnaires are designed to ferret out activities that you may be engaging in within the state, and your answers can trigger further inquiries. Hence extreme care should be taken when responding to their questions. Seeking professional tax help is highly encouraged because simply checking "yes" to some questions can easily lead to a determination of nexus. If your activities in the jurisdiction are limited, it might be better to respond with a letter in lieu of completing the questionnaire. And don't wait to see if you get a second request!

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- Nexus task forces are state revenue department commando units. They are actively looking for companies with activities in the state to prove nexus. Among their hunting grounds are truck weigh stations, trade shows, large construction projects, and airports, harbors, and even marinas. They don't even have to be out patrolling—they can sit back and conduct highly fruitful website and phone directory research as well.

- Multi-State Tax Commission audits are another way to get snared. The Multi-State Tax Commission has a joint audit program open to participating member states. Participating states nominate and vote on which companies to target, and the commission then conducts an audit on behalf of all the states concurrently.

- Audits of your customers and vendors add yet another net in which to catch you. During an audit of your customer, your supplier invoices will likely be reviewed. If there have been charges for on-site training or other services, that serves as proof that the vendor has had an in-state presence. In fact, a nexus questionnaire might not even be sent—just a notice of an audit appointment.

II. DETERMINING YOUR NEXUS EXPOSURE

With taxing jurisdictions going all out to prove your nexus exposure, your first line of defense is to stay on top of the exposure yourself, so that you are not at risk of underreporting and underpaying taxes. The troublesome thing is, this is very hard to do across all 50 states and other jurisdictions, especially given the complexity and changeability of the rules.

Do you have individuals who refer customers to your website via a link on their website and receive commissions for orders placed via those referrals? This can result in "click-through" nexus in states that have passed legislation.

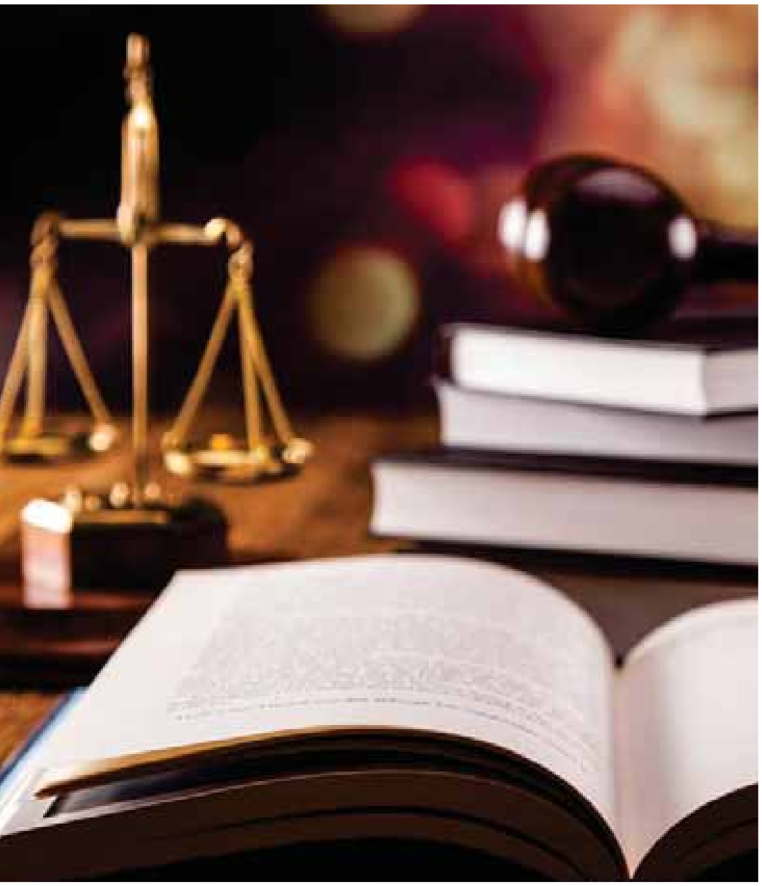
Pinpointing the basic activities that create nexus

The first step is to evaluate all the activities you are engaged in, in each jurisdiction where you do business. During this review, you need to answer such fundamental questions as:

- Where do you maintain a permanent place of business? This includes corporate offices, sales offices, warehouses, manufacturing facilities, and leased property at customer locations.

- Where are you operating, or have you operated, a temporary place of business? This includes trade show booths and suites, sales meetings, training sites, and movable equipment at work sites. It can also include consigned inventory at a customer location or inventory held at a fulfillment house (if you still own it).

- Where do you have individuals permanently operating on your behalf? This includes administrative employees, employee salespeople, manufacturer representatives, service personnel, and agents. And yes, they don't have to be employees to establish nexus for you!



- Where do you have individuals temporarily operating on your behalf? This includes traveling sales people, traveling manufacturer representatives, traveling service personnel, owned delivery vehicles and agents.

- Where do you have individuals who refer customers to your website via a link on their website and receive commissions for orders placed via those referrals? This can result in "click-through" nexus in states that have passed legislation. Note that you typically must meet a sales threshold in the state before click-through nexus applies. As of August 5, 2014, 15 states have enacted "click-through" nexus legislation.

- Where do you hold a substantial interest in, or are owned by, an in-state retailer and the retailer sells the same or a substantially similar line of products under the same or a similar business name, or the in-state facility/employee is used to advertise, promote, or facilitate sales to an in-state consumer?

- This can result in "affiliate" nexus in states that have passed legislation. As of August 5, 2014, 16 states have enacted affiliate nexus legislation. To view up-to-date news items on states that have passed click-through and affiliate nexus laws, visit **here** and enter "nexus" under Category.

Federal legislation has been introduced that would authorize states to require remote sellers to collect and remit their state and local sales and use taxes.

- To add complexity and uncertainty to all of these issues, federal legislation—The Marketplace Fairness Act of 2013—has been introduced that would authorize states that meet certain requirements to require remote sellers that do not meet a "small seller exception" to collect and remit their state and local sales and use taxes. This legislation is very polarizing and there are strong opinions on both sides. Given that the US Supreme Court has failed to hear any sales tax nexus cases since 1992 when they indicated Congress should fix the sales tax nexus issue, it may be time for something like the Marketplace Fairness Act to pass.

- The legislation was introduced on February 14, 2013 in both the US House and Senate. It was passed by the Senate on May 6, 2013. On September 18, 2013, Rep. Bob Goodlatte, the chairman of the House Judiciary Committee released a set of seven principles that he believes any internet sales tax bill should meet.

- On March 12, 2014, the U.S. House Judiciary Committee held a hearing called "Exploring Alternative Solutions on the Internet Sales Tax Issue."

- The Senate has recently proposed an alternative version of the bill by combining it with a 10-year extension of the Internet Tax Freedom Act, which is due to expire on November 1, 2014. It will be interesting to watch the developments and the debate about this issue. For more information and to view the status of The Marketplace Fairness Act of 2013, visit **marketplacefairness.org**.

That's the easy part. Now it gets more nebulous and difficult.

MONITORING YOUR BUSINESS FOR NEXUS

The next step—and it's an on-going one—is to monitor your business for nexus. You need to constantly stay on top of the level of activity and visibility of the activities. This is where many of the complexities and state-by-state idiosyncrasies raise their heads.

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To begin with, you need to monitor the frequency and duration of your visits to a jurisdiction, and you need to be aware of each jurisdiction's rules. Certain activities might have safeguards to limit nexus. These not only vary by state but also by activity. For example:

- Are you doing trade shows? Trade show rules differ by state. In California, it takes 16 days of trade show activity in a 12-month period to create nexus. But in Texas, just one day suffices.

- Do you have an employee actually residing in a state? In all states, that alone is enough to create nexus.

- Did you sign a contract in a state? That significantly raises the chance of nexus, even if it was your agent and not your employee who signed.

- Did you send anyone to perform installation or training services? If so, you're creating nexus, whether it's your agent or employee providing the services.

- Did you ship products into a state via common carrier or company leased or owned truck? If it's a common carrier, you're probably okay. But if it's your owned or leased truck, you've likely created nexus.

- Do you pay commissions to a sales or referral agent? If it is related to click-through there might be a sales threshold that applies but this may not protect you with a traditional sales rep earning commissions.

The visibility of your activities comes into play in determining how easily the state will find you but not whether you have nexus. States have greatly improved their ability to find remote sellers and identify presence in the state which creates nexus. For trade shows, if it was open to the public you might have actually talked to an auditor telling them everything you can do for them. Plus they actually visiting your "place of business" trade show booth. If you advertise locally, including providing in-state contact information in phone and industry directories, you have a target on your back. And if you are selling to any state or local agencies your nexus is now well-known as most states cross reference their suppliers against the registered taxpayer database. In fact, some states prohibit contracting with a supplier that isn't registered to collect sales and use tax in their state. It is important to alert your sales team that if any government contract or trade show registration packet includes a sales tax registration form that they send it to the finance or tax group for completion.

We've talked about what nexus is and how you get it, but you can have all the nexus in the world and have no issue or a giant one. This is what we call the economic impact of your activities. Understanding what the dollar value of your average sale into a jurisdiction is, when your sales and other activities commence, and what the total amount of sales into a jurisdiction since activities began all help to determine a potential liability.

You also have to determine what percentage of your sales is taxable. Some sales will qualify for an exemption. But it's up to you to know which are exempt and which are not, and you need to obtain proper exemption certificates for your exempt sales (don't count on being able to get them after the fact, because that isn't always allowed). How your invoices are written is important too. In some states, a normally exempt item becomes taxable if it is not itemized as a separate item on an invoice. Proper resale certificates are equally important. If they are not on file, an auditor will likely determine an error rate and project across the audit period to assess tax, interest and penalties.

So if all your sales are exempt, you might not have much to worry about in terms of a liability. Whether you choose to register or take the chance of discovery by the state is dependent on your risk tolerance. Not being registered leaves the prior periods open indefinitely in most states.

III. DEALING WITH NEXUS ISSUES

Now that you've gathered all the facts about your activities, what do you do when you discover you have created nexus? If you have just established nexus, it's simple: register with the jurisdiction(s) immediately and begin collecting sales tax. But if nexus was created sometime in the past and you haven't registered, then you have a decision to make. Fortunately, you also have some options to consider that may decrease the negative impact:

- Voluntary disclosure is a very good proactive option, provided it's open to you. In states with voluntary disclosure programs, the usual course is to write an anonymous letter to the state, under the aegis of a third party, describing your activities and their duration within the state.

- An agreement can often then be reached that leads to a limitation of open years and an abatement of penalties. The Multi-State Tax Commission mentioned earlier runs a national program enabling businesses to enter into voluntary disclosure agreements with multiple states.

- Whether to pursue voluntary disclosures directly with the state versus through the Multi-State Tax Commission requires an analysis of the pros and cons of each. An experienced state and local tax consultant can help you determine the right path for your business.

- Amnesty for uncollected or unpaid sales taxes is also available periodically as states implement amnesty programs. For states participating as members of the Streamlined Sales and Use Tax Agreement, amnesty may be available. Other individual states sometimes offer amnesty programs as well. You can find a list of amnesty program—current, future and past—that includes details on the program **here**.

- Don't register but monitor your activities and potential liability. In states where the liability is small or the activity is minimal, you may choose to take the wait and see approach. But, keep any eye on what is happening not only with your business activities but also with state law to know when you need to take action.

- Regardless of the approach you take, reach out to your customers and determine if they have either paid the use tax directly to the jurisdiction or qualify for an exemption. If they can certify that the tax has been paid or provide you with a valid exemption certificate, these amounts can usually be deducted from your liability for prior periods. However, relying on your customer to pay the tax going forward is not an option. If you have nexus, you have the obligation to collect the tax.

Be careful about when you start collecting

One thing you do not want to do is start collecting sales taxes prior to being registered with a jurisdiction—it's flat-out illegal and penalties can apply. In fact, in most states, this is considered criminal fraud. However, some states might let you start collecting the tax once you've filed for a voluntary disclosure even if your registration process is not yet complete. In these cases, you need to remit what you've collected immediately upon the completion of the registration. Also be sure to request this in the application and put the state on notice if there is any tax collected. If you don't, this could be considered a material misstatement that could invalidate any voluntary disclosure agreement.

One thing you do not want to do is start collecting sales taxes prior to being registered with a jurisdiction—it's flat-out illegal and penalties can apply. In fact, in most states, this is considered criminal fraud.

Nexus? Not!

Occasionally you may find yourself in the situation that you are registered with a jurisdiction, but there is no nexus. In these cases, you can contact the jurisdiction and cancel the registration. But it is not a slam dunk. You can expect to be scrutinized, so make sure you're correct in your evaluation.

In these situations, you can elect to continue to collect and remit taxes as a "voluntary filer" if you think there will be some business despite your lack of presence in the jurisdiction. If the state recognizes the voluntary filer status, there may be a reduced administrative burden such as less frequent filing frequency or simplified rates to apply. This doesn't apply often so don't expect it.

IV. MINIMIZING THE IMPACT OF NEXUS

If there is one takeaway we hope you have learned, it is that dealing with sales tax nexus, its implications, and the ever-shifting landscape of sales tax requirements is a complex and time-consuming process. It can also be very expensive, in terms of internal resources as well as penalties and interest if you don't get it right. According to a 2011 Aberdeen Group Research Brief on Sales & Use Tax Compliance Costs, the average annual cost of sales tax compliance wages ranges from $21,896 for small enterprises to $42,106 for midsize enterprises and to $49,627 for large enterprises. These costs include filing and remittance of sales tax, managing exemption certificates and calculation sales tax. These costs do not include any software, hardware or outside resources. Additional costs are incurred if an audit occurs during the year.

Clearly, for small to midsized companies, trying to manage sales tax compliance using only in-house resources and relying on manual processes is a costly mistake. If you're a fast-growing company, the mistake just compounds each time you enter a new revenue-hungry taxing jurisdiction, launch a new product or services, add a new line of business, acquire a new company, etc. Thus, it's highly advantageous to seek outside help, both to raise your sales tax compliance expertise and to bring down your costs of compliance.

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Be proactive. Don't wait until you receive a nexus questionnaire—leverage outside professional sales tax services and counsel to help you conduct a thorough nexus study of your activities upfront, and continue leveraging these expert resources as you grow to help manage your sales tax nexus profile.

We recommend the following course of action:

- Be proactive. Don't wait until you receive a nexus questionnaire—leverage outside professional sales tax services and counsel to help you conduct a thorough nexus study of your activities upfront, and continue leveraging these expert resources as you grow to help manage your nexus exposure. In the long run, it's substantially less expensive than trying to hire, train and maintain expensive in-house expertise.

- Automate. Manual processes for managing sales tax are time-consuming, resource-intensive and error-prone. Automation streamlines the process and eliminates the errors.

- Where this was once only an option for larger enterprises, new on-demand and managed services now enable small to midsized companies to enjoy the benefits of automation, coupled with a range of essential services including expert tax research, automated preparation of monthly audit data and signature-ready returns, and on-demand professional help in managing audits should they arise.

The one thing you don't want to do is trust that you can continually cover all the bases of nexus by yourself. Nexus is stealthy—it creeps up on you, leaving you sitting on a hidden penalty and interest time bomb. Nexus is multi-faceted—there are so many ways to fall into it, state by state. Nexus is dynamic—the rules change continuously. Nexus is necessary—at least to taxing jurisdictions, which are increasing creative and aggressive in their enforcement.

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About the Sales Tax Institute

The Sales Tax Institute is a premier think tank that offers live, webinar and online courses to educate business professionals about sales and use tax.

To learn more about understanding your nexus liabilities or managing the associated compliance obligations we encourage you to contact us.

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About YETTER

YETTER is a sales and use tax consulting firm that offers clients the highest quality sales and use tax guidance by understanding their needs, increasing awareness of current tax issues and trends, and providing effective tax-related solutions.

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