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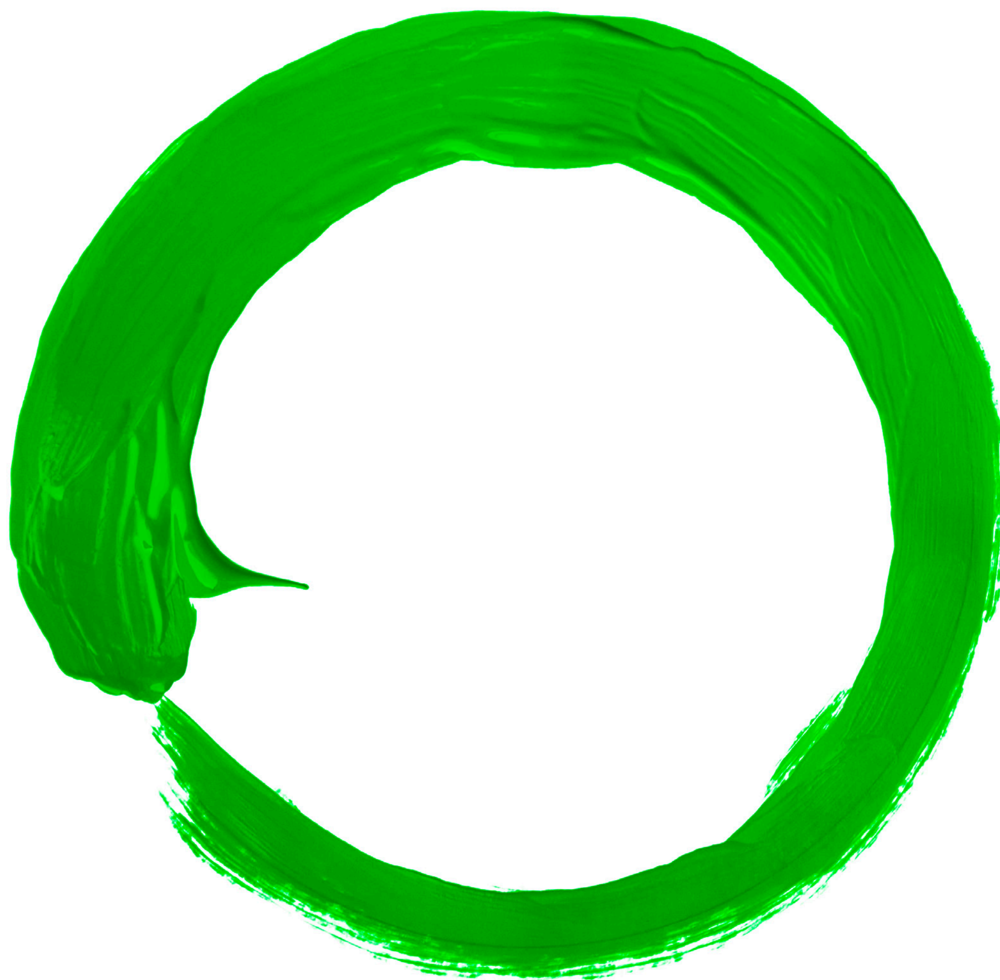

# Inside Deloitte

Income Tax Nexus Limitations in a Post-*Wayfair* World

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In this installment of Inside Deloitte, the authors examine possible limits on states' income tax nexus reach after the Supreme Court's decision in *Wayfair*.

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Before the *Wayfair*[1] decision, many states were pushing several theories to impose income tax nexus on out-of-state businesses, with strong resistance from taxpayers. Even though the case involved sales and use tax and not income tax, *Wayfair* opens the door even wider for states to assert nexus and raises questions for taxpayers as to how and when to fight against assertions of nexus.

Before *Wayfair*, the issue of how a business determined if it had a state income tax return filing obligation was relatively straightforward. The business began by considering its activities within the state and whether the activities constituted nexus as defined by the statutes, regulations, administrative guidance, and case law of that state. That required an analysis of any physical presence or other connections to the

[1] *South Dakota v. Wayfair Inc.*, 585 U. S. ___, 138 S. Ct. 2080 (2018).



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state. If the business was thought to have nexus, a secondary question arose of how much apportionment and income to source to the state. Before *Wayfair*, these were two separate questions with separate analyses. The apportionment issue was analyzed only if the nexus question was answered in the affirmative.

After *Wayfair*, these two questions are increasingly converging into one, often difficult to answer, question. Or at the very least, in many cases the two questions have reversed order. Now the first consideration may be whether the business has apportionment data, specifically whether a company has sales sourced to the state under the state's applicable apportionment rules. If that answer is yes, then in our post-*Wayfair* world, the nexus question may have already been answered as well.

### Nexus — Imposition Statutes Versus Constitutional Limitations

Nexus is really a two-part inquiry. First, does the state impose a statutory filing obligation on the business? Second, is the business, despite the statute, protected from that filing obligation by the U.S. Constitution, either by the due process clause or commerce clause, or by a federal statute such as P.L. 86-272?[2]

This first step, a careful review of a state's tax imposition statutes, is often overlooked because such statutes are generally written broadly and typically impose an income tax return filing obligation on any company that is "doing business" in the state or "deriving income" from sources within the state. For example, the Alabama corporate income tax is imposed on every "*corporation doing business in Alabama or deriving income from sources within Alabama*."[3] While imposition statutes have always been an appropriate first step in the tax nexus analysis, they have taken on greater importance in the overall nexus analysis post-*Wayfair*.

The second step in the nexus inquiry is the U.S. Constitution's limits on a state's taxing authority. This component of the inquiry is often litigated, and there is a line of Supreme Court case law providing a rough outline of its contours, which, for now, ends with the *Wayfair* decision.[4]

When considering the impact of *Wayfair*, the initial reaction may have been that it had very little effect on income tax nexus. *Wayfair*'s direct impact was eliminating the physical presence requirement and ushering in a new era of economic nexus for state sales and use taxes. But for years states have argued, often successfully, that the commerce clause physical presence rule was confined to sales and use taxes, and that state income tax nexus laws faced no such physical presence barrier.[5] Some states have imposed a *Wayfair*-like economic presence income tax nexus standard for over two decades.[6]

Upon further reflection, *Wayfair* may also mark an expansion of state income tax nexus. Even though economic nexus is not new to the income tax arena, many states have not previously pursued the full extent of economic nexus. States have often limited their use of economic nexus to two categories of taxpayers: related-party intangible holding companies and financial institutions, such as credit card banks.[7] While states have repeatedly argued that the physical presence rule did not apply to their income taxes, physical presence appears to have acted as a loose tether to the states, not stopping them at the bright line of physical presence but also not allowing the states to go too far past the line in most circumstances. States have been relatively passive internationally, generally not pursuing foreign companies that have U.S. customers but that lack U.S. permanent establishments and therefore do not file federal income tax returns. With *Wayfair* erasing the physical presence line, states may expand their

[2] P.L. 86-272 prohibits states from imposing income tax on businesses whose only activity in the state is the mere solicitation of sales of tangible personal property. P.L. 86-272 considerations are outside the scope of this article.

[3] Ala. Code section 40-18-2(a)(3) (emphasis added).

[4] This article does not go through the case law history of nexus but focuses instead on potential constitutional protections still available after the *Wayfair* decision.

[5] For example: *Geoffrey Inc. v. South Carolina Tax Commissioner*, 437 S.E.2d 13 (S.C. 1993), and *Tax Commissioner v. MBNA America Bank N.A.*, 640 S.E.2d 226 (W. Va. 2006).

[6] *Geoffrey* was decided in 1993.

[7] South Carolina's *Geoffrey* was the first of several state related-party intangible holding company cases, while West Virginia's *MBNA* dealt with an out-of-state credit card bank with in-state customers. In both instances the state supreme courts found enough contact for the states to exercise their income tax jurisdiction.



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imposition statutes, which may lead to an overreaching of state taxing authority. As a result, businesses will need to consider potential avenues of protection, including constitutional protection under the due process clause.

In the post-*Wayfair* world, there appears to be little, if any, practical difference between the due process clause's minimum contacts standard and the commerce clause's substantial nexus standard. Without the physical presence rule it becomes more difficult to find fact patterns that satisfy the due process minimum contacts standard but fail to satisfy the commerce clause substantial nexus standard. Perhaps the due process clause with its required "purposeful availment" of an in-state market is the rule that will control the nexus question into the future. If so, state income tax nexus has room to expand, but how far will the Constitution allow it to go?

The main post-*Wayfair* income tax nexus question is whether states will expand their imposition of economic nexus beyond related-party intangible holding companies and credit card banks to reach any type of business with a significant in-state market. All significant remote sellers, third-party owners of intangibles, and out-of-state service providers that deliver their products and services, often over the internet, to an in-state market should now be considering state income tax return filing obligations.

### Factor Presence, Market Sourcing, and Due Process Nexus

Many years ago the Multistate Tax Commission developed a model state income tax imposition statute, the so-called factor presence model statute.[8] The MTC model, as well as other similar factor presence statutes, look to the business's apportionment data, and if the business has more than a set amount of property, payroll, or sales in the state, the business has a filing obligation. At least 10 states have adopted the MTC model or another version of a factor presence statute.[9] Considering that more than half of all states use some form of market sourcing to determine if a business has in-state sales, the implication is clear: A substantial in-state market could result in an income tax return filing obligation. Some argue that factor presence statutes significantly reduce the subjectivity associated with the traditional doing-business or deriving-income statutes. Factor presence statutes focus the inquiry squarely on the sales factor and most often on how to source receipts from services and intangibles in a market-sourcing regime. Market sourcing is itself often a difficult analysis that relies heavily on the facts around each transaction or revenue stream. Also, states may take varying approaches on how they define the market, including whether the market is where the benefit is received or where the consumer or even a customer's customer is located. Businesses should understand the states' varying approaches and analyze the unique facts across the various jurisdictions.

States without a factor presence statute may take a renewed look at their traditional doing-business statutes as a result of *Wayfair*. Of interest to any state with a doing-business statute may be Justice Anthony M. Kennedy's description of Wayfair's connection to South Dakota, where he stated that Wayfair "availed itself of the substantial privilege of carrying on business in South Dakota."[10] As an online retailer, Wayfair had two types of contacts with South Dakota, in-state customers to whom it shipped products via common carrier, and its internet-based online sales platform, which the Court described as creating a substantial "virtual presence" in the state.[11] Kennedy's use of this language in *Wayfair* allows states to argue that their doing-business statutes are as broad as the constitutional nexus standard. *Wayfair* allows states to argue that a business with a substantial internet presence and sales into a state is doing business in that state and has a substantial nexus with that state that satisfies constitutional nexus concerns. For an income tax return filing obligation inquiry, this argument is a "two birds with one stone" analysis satisfying virtually any state imposition statute

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[8] MTC, "Factor Presence Nexus Standard for Business Activity Taxes" (Oct. 17, 2002).

[9] Alabama, California, Colorado, Connecticut, Hawaii, Massachusetts, Michigan, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Tennessee, Texas, and Washington.

[10] 138 S. Ct. at 2099.

[11] *Id.*



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and the constitutional nexus standard together at the same time. Remote sellers of tangible property, like Wayfair, who directly market their goods (aka *purposefully avail themselves*) to a state's consumers, appear squarely within the reach of most state imposition statutes and outside the protection afforded by the Constitution.[12]

Instead of selling tangible goods, many businesses provide services over the internet or own and license intangible property. Post-*Wayfair*, where are the constitutional nexus limits for providers of products and services delivered online or for out-of-state owners of intangibles? In today's online economy, the combination of factor presence statutes with market sourcing sales factor statutes may produce a filing obligation and liability for businesses that states have not traditionally pursued. The MTC model market-sourcing statute and rule source receipts from intangibles to the state where the intangible is used.[13] For example, consider the intangibles associated with a popular book, movie, or video game accessed remotely via the internet with no actual downloading of any physical property. The intangibles are likely used or consumed in almost every state and could produce significant revenue from consumers in every state. Should a filing obligation and income tax liability attach to that revenue wherever it is earned? What about third-party companies that license the rights to directly exploit those intangibles through theme parks and movies in the United States? What if the intangibles originate in another country? Market sourcing seems to allow factor presence statutes to reach the owners of intangibles no matter how far away they may be or how many intermediaries are between the state and the owner of the intangible, but are the creators of these types of intangibles purposefully availing themselves of the market in every state?

For the businesses that, like Wayfair, operate dynamic interactive customer-facing websites marketing directly to in-state customers, the question appears to have been answered. They are purposefully availing themselves of the state's market; they have minimum contacts and substantial nexus with the state. The Constitution likely offers no protection. But what about the owner of the intangible that is at least once removed from the state? The owner of the intangible licenses the right to exploit the intangible to a third party in exchange for a fee that is based at least in part on the third party's in-state revenue from the intangible. Is the once-removed owner purposefully availing itself of the in-state market? Does it matter if the owner and third party are related? Could unrelated third-party owners of intangibles be a bridge too far for state income tax jurisdiction?[14]

Like the internet, examples of these types of questions are seemingly endless. It will take time to figure out the answers, but some limited guidance is available.

## What Constitutional Limits Still Exist to Stop the Reach of State Taxation?

Recently the Louisiana Court of Appeal heard an income tax case involving personal jurisdiction under the due process clause.[15] Jeopardy Productions Inc., whose principal place of business is in California, entered into agreements with third parties for broadcasting rights to the *Jeopardy!* game show and licensing rights to use the trademark/logo on merchandise and gaming machines.[16] Jeopardy conducted its daily activities and licensing operations in California.[17] The game show aired on Louisiana-based broadcast stations, and gambling machines bearing the game show's trademark and logo appeared in casinos and truck stops around the state, resulting in $3,622,595 in royalty income from licensing agreements attributable to Louisiana.[18] The Louisiana Department of Revenue filed suit against Jeopardy to collect the corporate and franchise

[12] Again, P.L. 86-272 is another question not considered here.

[13] MTC, "Section 17 Model Market-Sourcing Regulations."

[14] In *Griffith v. ConAgra Brands Inc.*, 728 S.E.2d 74 (W. Va. 2012), the West Virginia Supreme Court held that the unrelated owner of the intangible did not have nexus, but in *KFC Corp. v. Iowa Department of Revenue*, 792 N.W.2d 308 (Iowa 2008), the Iowa Supreme Court held that the unrelated owner of the intangible did have nexus and was subject to the Iowa income tax.

[15] *Robinson v. Jeopardy Productions*, 2020 La. App. LEXIS 1517 (La. Ct. App. Oct. 21, 2020), *writ application denied*, 2021 La. LEXIS 130 (La. Jan. 20, 2021).

[16] *Id.* at *2.

[17] *Id.*

[18] *Id.* at *3.



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taxes related to the royalty income.[19] Jeopardy argued that Louisiana lacked personal jurisdiction because the corporation did not transact business in the state and its contact with Louisiana through unrelated third parties did not meet the level of minimum contacts necessary under the federal due process clause.[20]

In applying the due process clause principles, the court held that the out-of-state corporation lacked sufficient minimum contacts with the state to satisfy general or specific jurisdiction.[21] The court recognized that Jeopardy "made no intentional or direct contact with Louisiana."[22] The court considered Jeopardy's lack of authority and control over the third parties' contracting decisions regarding broadcasting the game show and distributing gaming machines and merchandise reflecting the licensed game show trademark and logo.[23] The court ultimately held that because the corporation did not directly or intentionally make contact with the state (that is, no purposeful availment), the corporation could not reasonably anticipate being sued in Louisiana and its contact with the state did not reach the level required for personal jurisdiction.[24]

As we see from the Jeopardy case, the due process clause can provide protection for an out-of-state business given the right circumstances. However, the constitutional protections available to taxpayers heavily depend on the circumstances.

Many years before *Wayfair*, the West Virginia Supreme Court issued a decision that discussed whether the commerce clause's substantial nexus prong required physical presence to subject a foreign corporation to the state's income tax.[25] MBNA America Bank, a Delaware corporation, had no employees or tangible or real personal property in West Virginia, and conducted business in the state solely through telephone and mail solicitation.[26] The supreme court held that the physical presence requirement only applied in the sales and use tax context and not state income taxes.[27] The court stated that "a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes."[28] The court found that MBNA had "systematic and continuous business activity" in West Virginia through promotion and solicitation of customers and significant gross receipts attributable to its activities in West Virginia.[29]

Several years after *MBNA* but before *Wayfair*, West Virginia considered whether physical presence is required under the substantial nexus prong in an income tax case involving royalty payments.[30] ConAgra Foods Inc. established ConAgra Brands Inc., a Nebraska corporation that conducted all its operations, including protecting and licensing intellectual property, outside West Virginia.[31] ConAgra Brands did not have any real or tangible personal property or employees in the state.[32] ConAgra Foods and its affiliates transferred trade names and trademarks to ConAgra Brands in accordance with a licensing agreement to pay royalties to ConAgra Brands to use the trade names and trademarks.[33] The royalties related to several brands that sold products to customers throughout the United States, including West Virginia, that used the trademarks and trade names.[34]

The West Virginia Supreme Court held that the state's assessments of tax against ConAgra Brands failed the substantial nexus prong under the commerce clause and purposeful direction under the due process clause.[35] The court stated that "a corporation may have the 'minimum contacts' with a taxing state required by the Due

[19] *Id.*

[20] *Id.* at *3-4.

[21] *Id.* at *8-9.

[22] *Id.* at *9.

[23] *Id.*

[24] *Id.* at *9-10.

[25] *Tax Commissioner v. MBNA America Bank N.A.*, 220 W. Va. 163 (2006).

[26] *Id.* at 164.

[27] *Id.* at 171.

[28] *Id.*

[29] *Id.* at 173.

[30] *Griffith v. ConAgra Brands Inc.*, 229 W. Va. 190 (2012).

[31] *Id.* at 192.

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.* at 200.



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Process clause but lack the 'substantial nexus' with that state required under the Commerce Clause."[36] ConAgra Brands lacked a physical presence in West Virginia, did not distribute the IP-bearing products or provide services in the state, the IP-bearing products were manufactured by affiliated or unrelated licensees outside the state, and ConAgra Brands had no control over product distribution.[37] The court distinguished ConAgra Brands from the *MBNA* decision by noting that ConAgra Brands did not solicit customers in West Virginia, unlike MBNA.[38] The court also held that even if ConAgra Brands satisfied the due process clause in accordance with *MBNA* and *Quill*,[39] the assessment would fail the commerce clause's substantial nexus prong.[40]

Thus, in West Virginia the same court reached two different conclusions on nexus based on the specific circumstances and how the constitutional protections apply to those circumstances.

### Where Do We Go From Here? What Is Next?

As is evidenced by the cases discussed, nexus is a very fact-specific determination, and the U.S. Constitution still provides protections for companies given the right circumstances. Now that the remote seller physical presence question has been addressed, look for the courts to consider more and different nexus questions, including:

- Nontax personal jurisdiction cases. After *Wayfair*, the commerce clause and due process clause nexus standards have come back together so that there is little room between the two. This rejoining of what were once two separate standards places more emphasis on the U.S. Supreme Court's nontax due process jurisdiction cases. Opinions considering whether a state has personal jurisdiction over a business in a product liability lawsuit may set new income tax nexus standards for taxpayers doing business online or through intermediaries.
- Purposeful availment, intermediaries, and stream of commerce. Content owners who do not exploit their intangible goods and services directly, but who share profits with third parties who take the content owners' intangibles to markets across the country, may argue that they are not purposefully availing themselves of state markets. States may argue, though, that the content owners are placing their products in the stream of digital commerce that flows to the state and thus must pay their fair share.
- Location of online markets. Businesses that reach their customers online may argue that those customers are coming to them, and the business has no taxable connection to the customer's state. States may argue that online businesses are using the internet to reach out to in-state customers, thereby purposefully availing themselves of the state's market and subjecting themselves to tax.
- Undue burdens. Will *Wayfair*'s "undue burden" standard be meaningful? Will we find fact patterns where a state that is otherwise within constitutional limitations to assert its tax jurisdiction ultimately fails the constitutional test because the state's tax system is too burdensome?
- Remote employers. For decades remote sellers have been at the forefront of the state tax nexus fight. Today we have new state tax nexus concerns around remote employees and their remote employers. Is an employer purposefully availing itself of a state's labor market if it hires an employee and allows that employee to work from anywhere and the employee chooses to work in the state?
- Passive investors. A nexus question that is still largely open today centers on states' tax jurisdiction over passive owners. Generally, states choose to answer the question with a no when it comes to the shareholders of corporations (but not S corporations) and a yes when it comes to the partners and members of partnerships and limited liability companies

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[36] *Id.*

[37] *Id.*

[38] *Id.* at 198.

[39] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[40] *Id.* at 200-01.



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(passthrough entities). Most state tax systems are designed with this jurisdictional dichotomy in mind. But oddly, the case law in this area is underdeveloped. With the continued expansion of passthrough entities into traditional corporate business territory and the distinction among shareholders, partners, and members blurring, this issue may rise to the forefront soon.

## The Need for Restraint and Clarity

With traditional federal constitutional restrictions lifting, and uncertainty regarding the location of the new boundaries, state policymakers should exercise restraint. Similarly, federal policymakers, namely Congress, should provide the clarifying guidance the Supreme Court expected after *Quill*, but which is yet to manifest in legislation.

The dominant role e-commerce, intangibles, digital services, and a mobile workforce play in today's economy demands more certainty about who is subject to a state's tax jurisdiction and when. It may not be enough that a taxpayer's revenue can be indirectly traced back to an ultimate consumer in the state. While traditional physical presence may no longer be the appropriate proxy for nexus and state income tax jurisdiction, some rule articulating a clean, clear connection between the taxpayer and the state is needed to take its place. That rule, whether articulated by the states themselves or by the federal government limiting state tax jurisdiction, should focus on both the size of the taxpayer's connection to the state and the directness and intentionality of that link between the taxpayer and the state.

History shows us that the development of such a rule may not be easy, but it is arguably necessary. If legislative bodies do not produce such a rule, litigation and the courts may be required to do so. If states overreach, the pendulum that swung in their direction to eliminate the physical presence rule could swing back in the other direction to cut off unreasonable efforts to extend the state tax base beyond state borders.

## Conclusion

In the post-*Wayfair* world, states may seek to expand their income tax nexus reach based on economic nexus theories. As a result, an out-of-state business must take a detailed look at its activities in determining whether it has nexus in a jurisdiction. With factor presence nexus standards and the trend toward market-based sourcing, states are reaching to tax businesses that have traditionally not been part of the tax base. This leads to the question of what constitutional protection is still available to businesses and where are the limits on a state's nexus reach. The due process clause may be the answer to businesses seeking protection from overreaching state income tax imposition, but more litigation may be necessary to ultimately determine where that protection begins and ends, and what, if any, incremental protections may still be available under the commerce clause. ■



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