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Evaluating the Tax Hangover: Trailing Nexus

by Adam B. Thimmesch

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In this article, which is adapted from a longer law review article, Thimmesch examines the concept of trailing nexus. He argues that the concept is consistent with the physical presence standard and proposes an economic latency approach, which he asserts is consistent with both constitutional principles and economic reality.

Discussions of tax nexus tend to focus on when a taxpayer's contact with a state is sufficient to create the substantial nexus required by the dormant commerce clause. That question, though still debated, is largely answered as a practical matter at this point. Physical presence is required to create nexus for purposes of state sales and use taxes, and economic nexus appears sufficient for other types of taxes.[1] This does not mean that nexus discussions are over — far from it. Indeed, one issue that has gained more prominence in recent years involves the other side of the nexus question — not when it begins, but when it ends. This article analyzes the trailing nexus issue and concludes that an economic latency approach is the best approach.[2]

The trailing nexus issue applies equally to both state sales taxes and state business activity taxes, but it is most prominent for purposes of the former. The uncertainty regarding economic nexus and the wide variety of economic nexus policies that have been enacted[3] means that the questions regarding trailing nexus and economic nexus are largely the same at this point. Until more clarity develops on economic nexus, a detailed discussion of trailing nexus under that model is premature.

The inquiry is much different under the physical presence rule. Under that rule, we know that sales tax nexus exists if a vendor has a physical presence in the taxing state. One could presume then that sales tax nexus does not exist after the vendor concludes its physical presence in the forum. However, this is not the way that many states treat sales and use tax nexus.[4] The Minnesota Department of Revenue, for example, requires that taxpayers remit the state's use tax for 11 months after the month in which their physical presence ends.[5] California states that sales tax nexus ends with a vendor's loss of commercial benefits from its prior physical presence.[6] The obvious question is how these policies are permissible under the physical presence rule. By extending state power past the cessation of a taxpayer's physical presence, those policies seem to directly conflict with that mandate.[7] Notwithstanding that initial impression, my analysis shows that trailing nexus is constitutionally permissible. I also conclude that a trailing nexus standard based on an economic latency approach would best harmonize states' interests in raising revenue from those who exploit their markets, taxpayers' interests in clarity, and our national interest in a strong interstate commercial market.

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[1]Of course, this latter point is hotly debated, but state courts are acting nearly uniformly to uphold economic nexus standards, and the Supreme Court has shown no interest in inserting itself to overturn those results. *See* Adam B. Thimmesch, "The Illusory Promise of Economic Nexus," 13 *Fl. Tax Rev.* 157, 173-176 (2013).

[2]For a more in-depth treatment of this subject, particularly issues regarding an economic nexus model, see Thimmesch, "The Tax Hangover: Trailing Nexus," 33. *Va. Tax Rev.* 497 (2014).

[3]State economic nexus standards are widely varied. *See* Thimmesch, *supra* note 1, at 173-187 (discussing the range of current economic nexus policies and their weaknesses).

[4]Bloomberg BNA, "2013 Survey of State Tax Departments," S-10 (2013) (stating that 35 states would find nexus for an entire tax year regardless of when the taxpayer ceased its nexus-creating activity); "Must Taxpayer Continue to Collect Tax After Nexus Has Been Terminated?" Peisner Johnson & Co. (Nov. 27, 2012) (reporting that 17 states impose sales and use taxes after a vendor's physical presence in a state ends).

[5]Minn. Dep't of Rev., Revenue Notice 00-10.

[6]Cal. State Bd. of Equalization, Letter Ruling 220.0275 (May 1, 2009).

[7]Perhaps consistent with this view, Texas is considering restricting its current trailing nexus policy. *See* Eric Yauch, "Texas Considers Dropping Trailing Nexus," *State Tax Notes,* Aug. 11, 2014, p. 373.

I. Trailing Nexus

A. Types of Trailing Nexus Policies

Most states indicate that they apply some form of trailing nexus, at least for purposes of state business activity taxes.[8] Only half as many apply trailing nexus policies specifically for purposes of state sales and use taxes.[9] Despite those survey responses, however, only a few states appear to have any published guidance on trailing nexus. Those states' policies can be divided and classified in several ways, including by looking at (1) the form of the state's guidance, (2) the type of tax to which the policy applies, and (3) the type of standard adopted.

Regarding the form of state policies, only Washington has a statutory trailing nexus provision. Other states with trailing nexus policies all rely on regulations, administrative publications, or other informal policies. Of those policies, there is a nearly even split on those that are directed at income taxes versus those that are directed at state sales and use taxes.

Most importantly, however, are the types of policies enacted. Some states adopt policies that are based simply on the passage of time after the taxpayer ceases its nexus-creating activity.[10] Those standards often use some variation of a one-year period. Texas's regulation, for example, provides that "an out-of-state seller who has been engaged in business in Texas continues to be responsible for collection of Texas use tax on sales made into Texas for 12 months after the seller ceases to be engaged in business in Texas."[11] Other states have adopted subjective standards that reference either a reasonable period of time[12] or look to the lingering benefits of the taxpayer's prior physical presence in a state.[13] Missouri actually takes a combined approach and requires use tax remittance for a reasonable period of time after the vendor concludes its physical presence, but it also provides a presumption that nexus continues for at least one reporting period. Notably, only a few states appear to have formally rejected trailing nexus.[14]

B. Is Trailing Nexus Permissible?

Regardless of their type, state trailing nexus policies raise significant questions regarding the meaning of the U.S. Supreme Court's physical presence rule. The traditional understanding of that rule suggests that trailing nexus policies are impermissible because they extend a state's authority past the cessation of a taxpayer's physical presence. That construct, however, presumes that the physical presence rule requires a taxpayer to have a current physical presence any time that a tax is imposed. Analysis of the Court's nexus opinions shows that such a presumption is incorrect. The Court simply has not given any clear direction on that aspect of the physical presence requirement.

1. What We Know About the Physical Presence Rule

The physical presence rule was developed in a series of early to mid-20th-century cases culminating in the Court's 1967 decision in *National Bellas Hess v. Illinois*.[15] That case is often identified as the origin of the physical presence rule, but the Court's decision actually provided very little on its content. The Court simply recognized that it had "never held that a State may impose the duty of tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail."[16] The Court then declined to abandon "the sharp distinction [that its prior cases had] drawn between mail order sellers with retail outlets, solicitors, or property within a State, and those who [did] no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."[17] Unfortunately, those statements represent the extent of the Court's enunciation of what is today known as the physical presence rule.

The Court reviewed its *National Bellas Hess* decision 25 years later in *Quill Corp. v. North Dakota*.[18] Again, however, the Court offered no real guidance on the limitations of the physical presence test. Its decision provided an extensive review of the history and purposes of its due process and dormant commerce clause jurisprudence, but it gave no real explanation for why physical presence mattered substantively or of the parameters of the physical presence rule. The Court simply upheld that rule (under the dormant commerce clause), citing principles of *stare decisis* and extolling

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[8] Bloomberg BNA, *supra* note 4, at S-10.

[9] *See* Peisner Johnson & Co., *supra* note 4 (reporting that 17 states apply trailing nexus provisions for state sales and use taxes and that 22 states responded that they do not apply trailing nexus provisions for those purposes).

[10] *See, e.g.*, Wash. Rev. Code section 82.04.220(2)(2013) (one-year period for the state business and occupation tax); Wash. Admin. Code section 458-20-193(7)(c)(2013) (five-year period for state sales and use tax); 34 Tex. Admin. Code section 3.286(b)(2)(2013) (12-month period); Iowa Dep't of Rev. Policy Letter 06240045 (May 30, 2006) (nexus continues for the remainder of the calendar year).

[11] 34 Tex. Admin. Code section 3.286(b)(2)(2013).

[12] Mo. Code Regs. Ann. title 12, section 10-104.030(3)(A)-(B)(2005); Colo. Dep't of Rev., General Information Letter 2007-5 (2007); Mich Dep't of Treasury, Revenue Admin. Bulletin 1999-1 (1999) at 4.

[13] S*upra* note 6.

[14] *See, e.g.*, Tenn. Dep't of Rev., Rev. Rul. 05-25 (2005) at 2, 4; N.Y. State Dep't of Taxation and Finance, Advisory Opinion TSB-A-98(66)S (1998) at 4-5; Va. Dep't of Taxation, Ruling 98-67 (1998).

[15] *See National Bellas Hess Inc. v. Illinois Dep't of Rev.*, 386 U.S. 753 (1967).

[16] *Id.* at 758.

[17] *Id.* at 760 (placing *National Bellas Hess* into the latter category of retailers and finding that the state lacked the power to impose its tax obligations on the company).

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

the virtues of bright-line rules, including reducing litigation and encouraging commerce by providing certainty.[19]

After *Quill*, we are thus left with the distinction made by the *National Bellas Hess* Court between (1) mail-order sellers with current physical presence in the taxing state and (2) those sellers who do no more than communicate with in-state customers by mail or common carrier as part of a general interstate business. Unfortunately, that distinction tells us little about the parameters of the physical presence rule. It certainly sets out two distinct categories of vendors, but it does not tell us about how the physical presence rule applies in other situations.

The two categories set out by the Court simply do not encompass all the potential classifications of vendors. For example, a vendor without a current physical presence could certainly have more connection to the state than through the mail or common carrier as part of a general interstate business. It could periodically enter the state or target the state's customers specifically. The two categories noted in *National Bellas Hess* are thus fairly viewed as points on a continuum. A vendor with a prior, but not current, physical presence may not fall entirely on the side that allows taxation, but it similarly does not fall on the side with vendors that have never entered or specifically targeted the state.

What this analysis shows is that trailing nexus is not necessarily inconsistent with *Quill* or the physical presence rule. The Court simply has not provided us with enough guidance on that rule to make that determination. We must therefore dig deeper into the Court's rationale to analyze the validity of trailing nexus.

2. What Does* Quill *Tell Us About Trailing Nexus?

Although the Court has not provided us with any actual formulation for the physical presence rule, we may be able to glean some guidance from the Court's reasons for adopting that rule. One reading of *Quill* is that the Court showed a concern about vendors being subject to compliance burdens that are disproportionate to their revenue.[20] The *Quill* Court did, after all, reference the significant number of U.S. sales tax jurisdictions and the burdens that vendors could face if subject to all of their individual tax requirements. We could thus presume that the Court believed that physical presence ensured that vendors were not subject to tax requirements that were overly burdensome. Analysis of that rationale, however, shows that it has nothing to do with physical presence as physical presence. Physical presence does not reduce the costs of compliance in and of itself. A vendor that steps foot in a state is no more able to shoulder the burdens of that state's tax than one that stays just outside the state. Similarly, a vendor's compliance costs are no greater if it recalls an in-state salesperson or removes inventory from the state.

The real benefit of the physical presence rule, from a cost standpoint, is simply that it restricts state power using a bright-line standard. The Court favored such a standard because it believed that bright-line rules reduce litigation, encourage settled expectations, and foster investment.[21] The physical presence rule thus provides a benefit not because physical presence matters but because it is a clear rule limiting state power. That difference matters.

The main takeaway from this analysis is that trailing nexus must be evaluated not by reference to a taxpayer's physical presence but by whether trailing nexus would undermine the bright-line standard created by the physical presence test. On this metric, trailing nexus appears to have an uphill battle, even though *Quill* may not be a direct hindrance. Nexus that extends beyond the end of a taxpayer's physical presence in a state initially appears to obliterate the bright-line guidance provided by the rule. Deeper analysis, however, shows that it does not.

First, one must recognize that the physical presence rule could provide two different types of bright-line rules — a bright-line condition to state taxing power or a bright-line threshold to that power. The former would distill nexus down to a single question: whether nexus exists. I argue, however, that the nexus question must be disaggregated into two questions — when a taxpayer's nexus begins and when it ends. Under that construction, a taxpayer's physical presence could be the bright-line point at which nexus commences but be irrelevant to when nexus terminates. Physical presence under that construct would be a mere threshold to a state's power.

This threshold concept may initially appear questionable. Nexus has never been viewed in this way. Ultimately, however, even a rudimentary analysis shows that the physical presence rule must be viewed as a threshold for taxation rather than a necessary condition to that power. Imagine, for example, a vendor from State A that sends a salesperson into State B each Monday for the entire business week (and that otherwise has no physical presence in that state). The salesperson returns to State A each weekend for rest and relaxation. Is the vendor free from collecting State B's tax on sales that it completes during its two-day physical absence? Certainly nobody would argue that, yet physical presence as a condition to taxation would apply that way. Similarly, presume that our salesperson returns to State A each night. Should the vendor be free from taxation on any sales made before morning? What if the salesperson also leaves the state for lunch? What if the salesperson solicits sales in State B for one month and only collects orders in the next, when safely

[19] *Id.* at 314-318.

[20] *Quill*, 504 U.S. at 313, n.6. Although the Court did note concerns regarding whether remote vendors receive the benefit of state services, that concern does not compel a physical presence requirement as a substantive matter. Vendors can certainly receive benefits from state expenditures even if not physically present there. Thimmesch, *supra* note 2, at 513, n.71.

[21] *Quill*, 504 U.S. at 315-316.

confined to State A? Is physical presence lacking under *Quill*? Again, nobody would take such a formalistic position, but physical presence as a true condition would operate just that way.

Physical presence as a condition simply does not make practical sense. A vendor's constitutional nexus with a state cannot switch on and off as a taxpayer moves about the country. This is not only logical, but it is consistent with prior Supreme Court and state court case law that upheld tax impositions on transient vendors without any analysis of their physical presences when the tax was imposed or owed.[22] In those cases, the vendors all traveled in and out of the taxing state and had no permanent physical presence there. The reviewing courts all looked simply to the vendors' establishment of some quantum of a physical presence but did not question when that physical presence occurred or when it ended in relation to the tax payment dates or the days when the taxable sales occurred.[23]

One may combat this analysis by distinguishing between transient vendors that frequently enter and exit states and vendors that have left a state with no intent to return. Only the latter, arguably, have truly ceased their physical presence. That distinction, however, necessarily accepts that a taxpayer's nexus continues without a current physical presence in the taxing state and that a taxpayer's nexus ends based on a subjective factor only known by the taxpayer (that is, its intent to return). Of course the former can be true only if physical presence is a mere threshold to state power and the latter conflicts with the Court's desire for bright-line rules in this area. Neither of these admissions serves the purpose of justifying physical presence as a condition to state power.

Once one accepts that a state can maintain jurisdiction over a taxpayer that does not have any current physical presence in that state, it is clear that physical presence is a threshold, not a condition, to taxation.[24] The relevant question is thus not whether physical presence trailing nexus is permissible but how long it lasts.

II. Evaluation of Trailing Nexus Policies

Once one accepts the validity of trailing nexus as a constitutional matter, it must be determined which form of trailing nexus is both most consistent with the goals of the Supreme Court and most comports with the administrative realities facing states. My analysis shows that none of the forms used by states are satisfactory under those metrics. Recall that state trailing nexus standards have taken two main forms: those based on set time limits and those based on some subjective factor. Analysis of these types of standards shows that they are less than ideal.

Time-based standards for trailing nexus are rational state responses and make sense as a matter of policy. They precisely establish the limits of a state's authority and provide bright-line guidance to taxpayers and tax administrators. Their main fault as a normative matter, however, is that they continue to use physical presence as their benchmarks. Each of these standards unnecessarily and inappropriately measures the end of trailing nexus from the end of a taxpayer's physical presence in the taxing state. This should not be accepted. As noted above, physical presence is relevant only for its provision of a bright-line threshold to a state's power. It holds no substantive significance beyond providing some limitation on state power. To allow or require state jurisdiction to lapse based on that factor may be administratively convenient, but it is both too narrow and too divorced from good tax policy to be proposed as an ideal standard.

Such standards are also difficult to adopt as a constitutional matter. Should the trailing nexus period run to the end of the taxpayer's current reporting period, to the end of the calendar year, for one year from the cessation of the taxpayer's physical presence, or for four years? There is no good judicial answer to this question because the mere passage of time following a vendor's physical departure from a state has no relevance to the issue of when that state's tax would unduly burden interstate commerce. The period of time is an administrative choice and more properly before a legislature than the courts. Time-based trailing nexus should not be adopted when better options are available.

States' subjective trailing nexus policies are similarly suspect. First, to the extent that those standards are based on a link between subsequent sales and a prior physical presence, they fail for the same reasons as time-based trailing nexus — they continue to unnecessarily exalt physical presence. There is nothing special about sales derived from prior physical presence. Those lingering benefit standards also raise collateral issues regarding both (1) the required causal link between a taxpayer's physical presence and its subsequent sales and (2) the exercise of jurisdiction over income rather than taxpayers.[25] Regarding the former, do lingering benefit standards require that a sale be clearly and directly the result of the vendor's prior physical presence (perhaps limiting nexus to orders submitted on forms delivered to the customer while the vendor was physically in the state)? Or will more indirect links suffice (perhaps sales attributable to the goodwill generated from an in-state visit)? Regarding the latter, would a vendor have to collect and remit tax on those

[22]*See General Trading Co. v. State Tax Comm'n of Iowa*, 322 U.S. 335 (1944); *Brown's Furniture v. Wagner*, 665 N.E.2d 795 (Ill. 1996); *Orvis Co. Inc. v. New York*, 654 N.E.2d 954 (N.Y. 1995).

[23]*See* Thimmesch, *supra* note 2, at 521-524 (discussing these cases in further detail).

[24]This is true even if one disagrees with this article's interpretation of the benefits or substantive purpose of the Court's physical presence rule. Even if one adopts a strict interpretation of that rule, one cannot avoid the conclusion that strict adherence results in absurd applications. Interpreting the physical presence rule to provide a bright-line condition to state taxation requires an unadministrable and untenable framework within which state power is determined.

[25]For further discussion, see Thimmesch, *supra* note 2, at 532-534.

sales with the requisite causal link but not on sales in the same month for which the causal link is not shown? That construct would go against the Court's current conception of the nexus requirement, which is that nexus gives a state power over a taxpayer and not over income.[26]

These questions show that such standards would be nearly impossible to administer, which would directly undermine the Court's goals of providing certainty and reducing litigation. This is true whether the subjective standard is based on a lingering benefit theory, as discussed above, or whether it is based on the taxpayer's intent to return to the state. Both types of approaches raise significant issues of proof. These types of standards are simply unworkable and conflict with the Court's conception of the nexus requirement.

Of course, states could also base the trailing nexus period on pure economic nexus concepts. Under that approach, trailing nexus could extend in perpetuity and require taxpayers to collect and remit tax in any period in which they have a single dollar of sales in the state. The permissibility of such a policy will ultimately depend on how the economic nexus debate is resolved. In the interim, there is a solution that provides many of the benefits of economic nexus without sacrificing the administrative and constitutional benefits of a more limited, bright-line approach.

III. The Economic Latency Approach

I propose a trailing nexus construct that terminates a taxpayer's nexus when its sales revenue from within the state experiences some requisite economic latency period. Specifically, this standard would provide that a person is not subject to the state's taxing power if (1) it has no physical presence in the state during the reporting period, and (2) it has made less than a specific amount in taxable sales in the state for a defined number of consecutive reporting periods after its last physical presence in the state. Such a standard would be preferable to those now in use because it simultaneously (1) provides bright-line guidance, (2) exempts de minimis market participants by using a threshold amount of sales as the key to the running of the latency period, (3) is administrable, (4) divorces itself from physical presence, and (5) can effectively counteract taxpayers' temptations to structure their affairs so as to terminate their nexus.

The proposed standard contains two variables that states would have to define — the period of economic latency and the particular de minimis threshold. The economic latency period brings with it several concerns. A period that is too short will be ineffective, while a period that is too long will raise constitutional questions. Ultimately, some form of the basic 12-month period used by many states seems like the most practical latency period for states to adopt. This is not to say that states could not adopt longer periods, but a one-year period seems to serve the goal of protecting state coffers while adhering to the purposes behind the physical presence rule and the dormant commerce clause.

Setting the de minimis sales threshold under an economic latency approach will likely prove to be more difficult. In an ideal world, state taxes would have no impact on interstate commerce, but that goal is impossible and not what the Constitution requires.[27] The actual limitation on states is that their taxes not unduly burden interstate commerce. Some burden is expected. Unfortunately, there is no formulation for determining when a tax burden becomes unduly burdensome. The *National Bellas Hess* and *Quill* opinions avoided that question by adopting the physical presence safe harbor. Once we move beyond taxpayers with current physical presence, establishing the correct standard becomes difficult. States should be concerned that low thresholds will be considered constitutionally suspect.

My longer article discusses more aspects that would be involved in setting the de minimis threshold, but suffice it to say that the task will not be easy for a state wishing to adopt a low threshold.[28] Administrative restraint is likely the best option. Choosing a threshold that is high enough that it does not unduly impede interstate commerce while still allowing the state authority over taxpayers that may have previously escaped state power is the goal. States should look to what revenue levels would justify their attention and the costs of complying with their tax laws. There appears to be room for states to adopt reasonable thresholds while still increasing their power from what they now exercise.

IV. Conclusion

Trailing nexus is an increasingly important issue. As states grapple with whether and how to formulate official trailing nexus policies, they should recognize that trailing nexus is on firm footing. Although the concept initially appears to conflict with the Court's physical presence rule, further analysis proves that wrong. Nexus does not terminate each time a taxpayer leaves a state. Rather, under the disaggregated view of nexus, it can continue. Trailing nexus is thus perfectly appropriate and consistent with both economic reality and the Court's precedent. Instead of the standards now used by states, however, states should consider an economic latency approach that more closely comports with good tax policy and recognizes the administrative and constitutional limitations on states' taxing efforts. ✰

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[26]*Nat'l Geographic Society v. California Bd. of Equalization*, 430 U.S. 551, 561 (1977).

[27]The Court has explicitly stated that "it was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938).

[28]Thimmesch, *supra* note 2.