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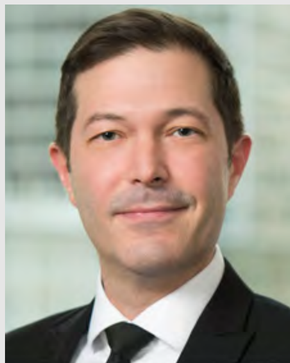
How the COVID-19 Pandemic Might Shape Corporate Income Tax Nexus

by Matthew S. Mock, Colleen M. Redden, and Cosimo A. Zavaglia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In this article, the authors analyze determination of nexus for remote workers during the COVID-19 pandemic.

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Remote working has become the norm for many companies in response to COVID-19, and in addition to creating operational challenges, it has corporate income tax implications.[1] One consequence of remote working is the imposition of state corporate income tax on employers as a result of an employee's physical presence in the state. Traditionally, the presence of employees in a state where a taxpayer engages in activities beyond the protection of Public Law 86-272 can create income tax nexus and a resulting filing obligation. However, the fact that workers are in the state because of COVID-19 restrictions may defeat imposition of nexus under due process and commerce clause standards. Further, physical presence as a nexus requirement has eroded over the years, with states moving toward economic nexus tests that have been approved by the courts.

With the current focus on nexus being one of economic contacts rather than physical presence, taxpayers may have a path to challenge a nexus assertion based on remote workers in the state. Arguments may include that the frequency, duration, and activities of remote workers in the state do not create economic contacts as required by our evolved definition of nexus. Given that some states have found nexus to exist without physical presence, we assert the relevance of physical presence should apply equally when a taxpayer has physical presence in the state. In other words, if physical presence is immaterial to finding nexus, why would physical presence indicate nexus if it is a taxpayer's only connection to the state? We explore this issue, considering COVID-19 and the

[1] There are implications for state taxes other than corporate income tax — for example, payroll taxes. However, this article focuses on corporate income tax.

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response to the changing landscape of the U.S. workforce.

Income Tax Nexus Under Constitutional Jurisprudence

The imposition of income tax must meet two distinct clauses of the U.S. Constitution — the due process and commerce clauses. Although phraseology and concepts may overlap, the U.S. Supreme Court has clarified that these clauses are satisfied under two separate analyses.[2] The due process clause requires a definite link — some minimum connection between a state and the person, property, or transaction the state seeks to tax — so as not to offend the traditional notions of fair play and substantial justice.[3] If a foreign corporation purposefully avails itself of the benefits of a state's economic market, it may subject itself to the state's jurisdiction, even if it has no physical presence.[4] Second, to meet due process the tax imposed must be rationally related to the values connected to the taxing state.[5]

The commerce clause requires application of the four-part *Complete Auto Transit* test.[6] The test asks whether the tax asserted applies to an activity with substantial nexus in the state, is fairly apportioned, discriminates against interstate commerce, and is fairly related to the services the state provides to the taxpayer.[7] Again, physical presence is not required for a tax to pass constitutional muster under the commerce clause.[8] Rather, the question is whether the taxpayer has "availed itself of the substantial privilege of carrying on business in that jurisdiction."[9]

Wayfair effectively removed the *Quill* physical presence requirement regarding sales tax, further affirming the Court's acceptance of economic contacts as being sufficient for creating nexus in the state. The *Wayfair* ruling gave credence to states that had already enacted sales thresholds, either in value or volume, for the imposition of sales tax and empowered additional states to adopt sales thresholds. Similarly, both pre- and post-*Wayfair*, the use of sales thresholds made its way to income tax as states adopted factor presence tests as an indicator of a corporation's nexus in the state. Generally, factor-based nexus provides that a taxpayer will be subject to income tax once the taxpayer exceeds a dollar amount in either sales sourced, wages paid to employees, or value of property in the state.[10] Not all states have adopted bright-line factor thresholds but still assert a taxpayer can create economic contacts in the state and thus create nexus with the taxing jurisdiction.[11] Physical presence remains a traditional indicator of nexus in addition to the economic indicators adopted by a handful of states.

Remote Working Cases

Given this backdrop, state courts have opined on the relationship of employees to income tax nexus. In *Telebright Corporation Inc.*, the New Jersey Superior Court found the corporate taxpayer had nexus in New Jersey based on the presence of one remote employee in the state.[12] The employee had started with the company at its headquarters in Maryland but relocated to New Jersey when her husband took a job there. Telebright's remote employee developed and wrote software from her laptop in New Jersey.

[2] *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992), *overruled on other grounds*, *South Dakota v. Wayfair Inc.*, 585 U.S. ___, 138 S. Ct. 2080 (2018).

[3] *Quill*, 504 at 307, citing *International Shoe v. Washington*, 326 U.S. 310 (1945).

[4] *Quill*, 504 at 307, citing *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). In nontax cases, the Supreme Court has stated substantial connection under the due process analysis must come from purposeful action of the person whom the state seeks to subject to its jurisdiction. *Asahi Metal Industry Co. v. Superior Court of California*, 480 U.S. 102 (1987).

[5] *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213, 2220 (2019); and *Hans Rees' Sons Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

[6] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

[7] *Id.*

[8] *Wayfair*, 138 S. Ct. 2080.

[9] *Id.*

[10] Ala. Code section 40-18-31.2; Cal. Rev. & Tax. Code section 23101; Colo. Code Regs. section 39-22-301.1(1); and Tex. Admin. Code section 3.586.

[11] For example, New Hampshire defined business activity as "a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization's economic contacts with the state." N.H. Rev. Stat. Ann. section 77-A:1(XII). However, the state has not adopted a factor threshold that defines what "substantial economic presence" means for the imposition of income tax.

[12] *Telebright Corp. Inc. v. Director, New Jersey Division of Taxation*, 38 A.3d 604 (N.J. Super. Ct. App. Div. 2012).

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The New Jersey corporate business tax is imposed on every corporation for the privilege of doing business in the state.[13] The court found that Telebright was doing business in the state by way of its employee in the state who created computer code that became part of Telebright's service offerings. The court determined that the presence of one employee who was producing a component of Telebright's service offerings satisfied the minimum connection requirement under the commerce clause.

Nor did imposition of the tax offend due process. Citing precedent, the superior court found that imposition of income tax on corporate taxpayer based on employing one full-time person in the state was not a violation of due process.[14] Also, Telebright's employee benefitted from the protections of New Jersey law, and Telebright would have access to the state's courts should it enforce restrictive covenants in the employee's contract. The court found Telebright had sufficient minimum contacts in satisfaction of due process. Thus, the imposition of tax was proper.

Conversely, in Letter Ruling 97-09, the Tennessee Department of Revenue found that the presence of taxpayer's corporate officer working remotely from his home in Tennessee did not create nexus in the state. The corporate officer wanted to move back to Tennessee for personal reasons, and the company — although opposed — accommodated his request. The taxpayer did not have customers in Tennessee. Further, the taxpayer had no employees or property in the state and it did not reimburse the officer for his home office expenses. The officer had a company-provided cell phone that was billed to the taxpayer in a different state. The officer's cell phone number was not on his business card nor was the address of his home office. The ruling found the taxpayer did not hold itself out as being available for business in Tennessee and therefore was not exercising its corporate function in the state.

State Response to Teleworking and Nexus Considering COVID-19

As of this writing, a handful of states have released guidance either through formal announcements or postings to their state taxing authority's website on whether the state will assert nexus based on remote workers in the state. Most states have remained silent on the subject. We have seen over the past several months that state guidance is fluid in relationship to the status of the COVID-19 pandemic.

Of the states that have released guidance, the directives have been somewhat mixed. Most revenue agencies have tied easing of nexus rules to a declared state of emergency or official work-from-home orders. However, this approach does not align with most companies' decision to keep workers at home past lapses of official orders but in accordance with guidance from local and federal health officials.[15] Other states have announced fixed deadlines for when the state will use the presence of employees in the state, regardless of COVID-19 concerns — as a consideration in finding the taxpayer subject to income tax.

The Georgia Department of Revenue posted on its website that it will not assert nexus, nor will a corporation lose P.L. 86-272 protection, while there is an official work-from-home order issued by federal, state, or local government or the employee must stay home under orders of a physician. Per its website, the Iowa DOR will not assert nexus based solely on remote workers while there is a declared state of emergency in Iowa or where the employee normally works. The DOR also said that it "does not believe that the presence of employees who normally work outside of Iowa, but who are now working remotely from within the state solely as a result of the COVID-19 pandemic state of emergency represents the same type of business activity on the part of the employer contemplated by the law." Iowa's commentary provides insight into its view of remote working as a result of COVID-19. However, publications or statements from other states describe an exemption from nexus as a result of remote workers being in the state during COVID-19, meaning normal nexus

[13]N.J. Stat. Ann. section 54:10A-2.3.

[14]*Telebright Corp.*, 38 A.3d 604, citing *Standard Pressed Steel Co. v. Department of Revenue*, 419 U.S. 560, 562 (1975), and *National Geographic Society v. California Board of Equalization*, 430 U.S. 551, 557 (1977).

[15]Facebook and Google are among a number of companies that have announced remote working plans to stay in effect until at least July 2021.

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rules would apply notwithstanding COVID-19. A state's silence on the matter likely indicates normal nexus rules apply.

The Massachusetts DOR released Technical Information Release 20-15 (TIR 20-15) wherein it advised on the corporate excise implications of employees teleworking in the state. The DOR said that during the effective period of the TIR, the presence of one or more employees in the state for a "pandemic-related circumstance"[16] alone will not establish corporate excise tax nexus nor will a taxpayer lose the protection of P.L. 86-272. Further, a corporation should not adjust its apportionment formula based on employees teleworking in the state. The COVID-19-related exceptions for nexus assertion under this TIR will only apply until 90 days after the state of emergency (the covered period) in Massachusetts is lifted.[17]

The covered period established by the TIR could subject taxpayers to Massachusetts excise income tax through no action of the taxpayer. The oddity in the state's guidance is that the period ends when Massachusetts lifts its emergency order and does not consider surrounding states that may still be under emergency declarations. Granted, Massachusetts has a factor presence threshold of $500,000 of sales, which could subject taxpayers to the state's corporate excise tax regardless of whether an employee is working in the state. However, to the extent a taxpayer does not meet the factor nexus threshold but has an employee working remotely in the state, the taxpayer may be subject to income tax. Further, a taxpayer asserting P.L. 86-272 protection may lose its protection because of the presence of the employee in the state.

The Oregon DOR posted to its website that "for purposes of Oregon corporate excise/income tax, the presence of teleworking employees of the corporation in Oregon between March 8, 2020 and December 31, 2020 won't be treated by the department as a relevant factor when making a nexus determination if the employee(s) in question are regularly based outside Oregon." This statement would imply that remote employees in the state after December 31, 2020, would trigger nexus for corporate excise and income tax. South Carolina announced in Information Letter 20-29 that it will not use the presence of remote employees in the state as a basis for nexus or change apportionment during the period of March 13, 2020, to June 30, 2021. Unlike Georgia, Iowa, and Massachusetts, Oregon and South Carolina have chosen a fixed date to impose nexus regardless of state health or emergency orders.

Defenses Available to Taxpayers

Corporations are somewhat limited in their ability to protect themselves from nexus assertion under the COVID-19 circumstances. However, taxpayers should evaluate their nexus footprint and potential risk of extended nexus based on teleworking employees. Creation of nexus in a state does not always result in a bad answer. Taxpayers should complete the analysis of creating nexus in a state by computing tax liability, considering decreases to state tax liability where the taxpayer is already filing due to gaining the right of apportionment and income tax rate differentials. Further filing in a state starts the clock on the statute of limitations, which can limit risk.

At a basic level, assertion of nexus as a result of telecommuting during COVID-19 may not meet the substantial nexus requirement of *Complete Auto Transit* in satisfaction of the commerce clause, which requires purposeful availment. Similarly, as it relates to due process, arguably the taxpayer has not purposefully availed itself to the state, creating the prerequisite minimum contacts in the taxing jurisdiction.

Although *Quill* was overturned by *Wayfair* with respect to its physical presence requirement, its due process analysis still holds true. The Court in *Quill* explained that a corporation that purposefully avails itself of a state's economic benefits will subject itself to the jurisdiction of the state, and thus imposition of tax does not violate

[16] A pandemic-related circumstance includes:
- a government order issued in response to the COVID-19 pandemic;
- a remote work policy adopted by an employer in good-faith compliance with federal or state government guidance or public health recommendations related to COVID-19; or
- the worker's compliance with quarantine, isolation directions related to a COVID-19 diagnosis or suspected diagnosis, or advice of a physician related to COVID-19 exposure.

[17] In TIR 20-10, the DOR had originally set a deadline as the earlier of December 31, 2020, or 90 days from the end of the state of emergency. The DOR removed the fixed date on December 8, 2020.

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due process.[18] If a foreign corporation purposefully directs its business into a jurisdiction, even without physical presence, the corporation may be subject to tax.[19] In the context of COVID-19 and remote working, one can argue that corporations have not purposefully directed or taken an affirmative act in the jurisdiction simply because employees are now remotely working there. Here, taxpayers' decision-making regarding remote working policies is in response to state executive orders and guidance from health organizations. In fact, early in the pandemic, companies had no decision to make and were required to keep workers at home. As the pandemic continues, taxpayers will be guided by concerns for workplace safety of employees rather than the desire to develop economic contacts in the state.

Additionally, due process requires that the income taxed by the state bear some rational relationship to the values connected with the taxing state. The inquiry is then whether the taxation of the income of a taxpayer with remote employees, who are only in the state because of COVID-19, bears a rational relationship to the value provided in the state where those employees are located. A state may argue that it is providing value to the company by providing a workforce or that the state is affording value to the employees. In *Telebright*, the court found that due process was satisfied in that the in-state employee enjoyed all legal protections afforded by New Jersey and that Telebright would have access to New Jersey courts to enforce the employee's contract. However, the employer did not actively seek the state's provided workforce or use of its courts because it is not located in the state. Further, the state-provided value to the employee is recovered when the employee is subject to personal income tax.

In addition, due process asks for the definite link between the state and the transaction it seeks to tax. In that analysis, frequency, duration, and activities in the state are considered. In *Telebright*, the court found the employee's physical presence in the state a sufficient link between the taxing state and income earned by Telebright. In the precedent cited in *Telebright*, the U.S. Supreme Court found taxpayers established nexus from a minimal workforce in the state when that in-state workforce performed sales functions.[20] The employee in *Telebright* did not serve a direct sales function for Telebright but developed products offered for sale by the company. However, consider the type of activities performed in the state by the employee. What if the employee had performed an administrative function, one that was not related to a business development or sales function? The inquiry, then, may be how attenuated can the connection between the in-state employee and the business of the employee be in order to create a "definite link, some minimum connection"? How minimal is minimum?

Or consider the Tennessee ruling that found the corporate officer in the state did not hold himself out as conducting business for the corporation in the state (e.g., worked from a home office, no corporate public listing in the state) and therein the corporation had not created minimum contacts in the state. Arguably, the Telebright employee in New Jersey was not holding herself out as conducting business for Telebright. Thus, her presence did not create Telebright's minimum connection to the state.

Under *Wayfair*, we know that the Constitution does not require physical presence to find nexus under the commerce clause for sales tax purposes. Given the U.S. Supreme Court's steadfast refusal to take economic nexus cases in other contexts, the consensus among practitioners is that this also applies to state income taxes. Again, purposeful availment is a basic tenet of substantial nexus under the commerce clause and is found when a taxpayer has directed business activities into a jurisdiction to take advantage of some economic benefit in the jurisdiction's market.[21] In *Wayfair*, the Supreme Court found South Dakota's bright-line sales tax threshold of $100,000 in sales or 200 transactions satisfactory in that it met the

[18] *Quill Corp.*, 504 U.S. 298, 306, *overruled on other grounds*, *Wayfair*, 138 S. Ct. 2080.

[19] *Id.* at 308 (1992), *overruled on other grounds* in *Wayfair Inc.*, 138 S. Ct. 2080 (2018), *citing Burger King*, 471 U.S. 462 (1985).

[20] *See Standard Pressed Steel*, 419 U.S. 560, 562 (1975) (finding presence of single employee in the state, responsible for one customer, satisfied due process because the employee was able to maintain a valuable customer in the state); *see also National Geographic*, 430 U.S. 551, 556 (1977) (finding taxpayer's two offices in the state, which sold $1 million worth of advertising copy annually establish substantial presence in satisfaction of due process).

[21] *Wayfair*, 138 S. Ct. 2080, 2099; and *Asahi*, 480 U.S. 102.

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substantial nexus prong of the *Complete Auto* test. The Court stated: "This quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota."[22] Taken in the context of remote working, would one remote-working employee in the state be sufficient for the employer to have availed itself of the substantial privilege of carrying on business in the state?

As our shifting nexus principles have moved toward examining economic contacts in terms of dollar value or volume of transactions in the state, arguably the physical presence of employees in the state — by itself — would be a non-factor for nexus creation. Consider a hypothetical. In March 2020, Company ABC, as mandated by state executive order, required its employees to work from home. A handful of its employees who serve human resources functions live, and now work, in State X where Company ABC did not previously have nexus and has no sales or transactions either before or during the time the employees worked remotely in the state. The remote employees do not advertise that they are working from home nor is there any indication that Company ABC is now in the state. Can it be said that Company ABC, through the presence of its human resources employees, has availed itself of the substantial business is carried on in State X? Arguably, Company ABC's remote employees have not created economic contacts for Company ABC in State X. Or, said another way, Company ABC arguably has not exploited the economic market of State X by the presence of its remote employees. Further, Company ABC's remote employees are not in the state at the direction of Company ABC but rather because of public policy or other health concerns. However, State X may argue that the presence of employees and property (e.g., laptops) in the state is a traditional indicator of nexus and therefore subjects Company ABC to state income tax. Further, consider if Company ABC has P.L. 86-272 protection in State X. Its makes sales to customers in the state from outside the state which are fulfilled outside the state. It arguably may lose that protection because it has carried on non-solicitation activities through its HR employees in the state.

Lastly, the scenario described above invokes a question whether the physical presence nexus standard should stand considering states' move to a single sales factor. In *Container Corp.*, the Court cited the traditional three-factor apportionment formula as having gained wide approval because payroll, property, and sales "appear in combination to reflect a very large share of the activities by which *value* is created." If apportionment is the measure of activities which create value in the taxing state,[23] the use of a single sales factor would seem to indicate property and payroll in the state are not value-creating activities. Is there an argument then that the imposition of income tax based on the presence of an employee working in the state is not rationally related to the values the state seeks to tax under due process?[24] In other words, if the state assigns no value to employees working in the state based on its apportionment factor, how can the state attribute and therein tax income to a state where the taxpayer has no value?

The scenario described above, and related constitutional issues, have been highlighted by COVID-19. However, this will remain an issue as companies move their employees to permanent remote working or offer remote working to employees. On a federal level, there have been unsuccessful attempts by Congress to create uniform rules for remote employees. Most recently, as part of the Senate Republicans' Health, Economic Assistance, Liability Protection and Schools Act (HEALS Act), an employer that would not otherwise be taxable in a state, except for the employees living in that state that are working remotely because of COVID-19, would not be subject to any registration, taxation, or other related requirements during the covered period. To date, the HEALS Act has not been passed by Congress. ■

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[22] *Wayfair*, 138 S. Ct. 2080, 2099.

[23] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 182 (1983) (emphasis added).

[24] *Norfolk and Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317 (1968).

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