

NEXUS AND FIN 48: States of Flux

The reporting requirements of FASB Interpretation no. 48 have exacerbated an already vexing matter for many CPAs and taxpayers—the uncertainty surrounding the tax issue of nexus. Much of that uncertainty derives from inconsistent adjudication of nexus issues by state courts and the absence of recent guidance from the U.S. Supreme Court or Congress.

PHYSICAL PRESENCE VS. ECONOMIC PRESENCE

When the Supreme Court last reviewed state nexus in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), it said a state could impose sales and use taxes only on a taxpayer that was physically present in the state. Subsequently, states have searched for ways to circumvent this limitation by adopting a variety of “economic presence” standards. For example, in 1993, South Carolina crafted an economic presence standard to assess income tax on a corporation that was not physically present in the state. Since then, courts and legislatures in New Mexico, North Carolina, Minnesota, Arkansas and, more recently, West Virginia and New Jersey have successfully applied economic nexus to impose income taxes on non-physically present companies.

The Supreme Court has failed to provide needed guidance in this area and recently declined to review the New Jersey and West Virginia cases. In *Lanco*, a case involving a trademark holding company, the New Jersey Supreme Court in 2006 used “affiliate nexus” to impose income taxes on an out-of-state seller that had affiliated companies operating in the state. In *MBNA*, a case involving a pure economic nexus issue, a West Virginia court imposed income taxes on an out-of-state credit card company that had no in-state affiliates. Similarly, the Massachusetts tax board recently ruled that the state could assess income tax on an out-of-state bank that had no physical presence in the state.

ENTER FIN 48

FIN 48 imposes a new recognition and measurement standard that requires taxpayers to analyze all outstanding income tax positions (that is, federal, state, local and international) with the expectation that each position would be reviewed in an audit. Taxpayers must determine whether the position is “more likely than not” to withstand challenge by the taxing authority.

Consequently, taxpayers and their advisers must carefully and continuously review the precedential value of state court decisions, statutes and administrative practices pertaining to nexus to make a realistic and reasonable judgment when applying the more-likely-than-not recognition standard and when estimating and measuring a tax benefit. The FIN 48 determination must be supported by well-documented and auditable evidence including a detailed analysis supporting the recognition and measurement requirements and a disclosure of open periods of assessment for unfilled returns. Furthermore, FIN 48 compels taxpayers that may be ensnared by economic or affiliated

nexus to review their decision not to file a return—a decision previously overlooked as a tax position.

TO FILE OR NOT?

If the more-likely-than-not standard is not met on the decision not to file, taxpayers are required to record an unrecognized tax benefit for the potential tax liability, which cumulatively can be a significant amount, since taxpayers who have never filed are not protected by a statute of limitations in most states. Alternatively, taxpayers and their advisers could seek ways to limit exposure for unfiled years by participating in state amnesty programs and entering into voluntary compliance and disclosure agreements. Alternately, taxpayers may simply avoid doing business in a state.

FISHING EXPEDITIONS?

But greater disclosure raises the question of how work papers will be used by state taxing authorities. Will disclosure trigger “fishing expeditions”? The IRS has said it will apply its usual policy of restraint to FIN 48-related tax-accrual work papers, but states could choose to treat them differently.

Just weeks after the Supreme Court declined to review *Lanco* and *MBNA*, Congress reintroduced legislation that would codify a physical presence standard and expand that standard into the income tax area (see “[Tax Matters](#),” page 84). Until Congress or the Supreme Court creates a uniform definition of nexus, taxpayers will continue to operate in a state of uncertainty in this area as they try to comply with the recognition and measurement requirements of FIN 48.

Lanco Inc. v. Dir., N.J. Div. of Taxation, U.S. No. 06-1236, cert. denied (6/18/07), and *FIA Card Services, N.A., fka MBNA Am. Bank, N.A. v. Tax Comm’r of the State of W.Va.*, U.S. No. 06-1228, cert. denied (6/18/07).

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