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The nexus tax: What franchisors need to know

BY: TAMARA FOX ROSE | INSIGHTS | ARTICLE

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As states across the country continually look for new sources of revenue, the economic presence standard, commonly referred to as the “nexus tax” has become a popular way for states to raise money from franchisors – even if those businesses don’t know they have to pay it.

Saxton & Stump attorneys have seen a distinct rise in the collection and enforcement of the nexus tax, as businesses who traditionally did not have nexus in a state due to a lack of a physical presence now have economic nexus based on revenues generated through business activities located in that particular state.

The tax could be confusing for franchisors, who don't technically own franchise locations but collect a fee from the franchisees that own and operate each location in the state.

Here's what franchisors need to know about the nexus tax on Pennsylvania and other states:

Q: What is the nexus tax?

A: The U.S. Supreme Court ruled in 2018 that online retailer Wayfair had to collect and remit sales tax if the seller had substantial nexus with the state. Substantial nexus was defined by sales volume rather than physical presence. While the Wayfair decision did not address taxes other than sales tax, individual states took the decision a step further and began applying economic nexus standards to various other taxes such as income, franchise, commercial activity, and other taxes on gross receipts.

Q: Who must file for and pay the nexus tax?

A: Any business who does not have physical nexus with a state must file and pay taxes if they meet the economic nexus requirements.

Q: How does this affect franchisors?

A: Many states included specific qualifications for a business's annual gross sales when determining whether economic nexus is created. In Pennsylvania, the "sale or licensing of intangibles, including franchise agreements" is included in the calculation of a business's annual gross sales. That touches many franchisors regardless of where their home offices are.

Q: Are the nexus tax rules and regulations for each state uniform?

A: No. The economic nexus standards vary state to state. In Pennsylvania, any business who does not have a physical presence in the state meets the economic nexus requirement for Corporate Net Income Tax reporting if they exceed $500,000 in annual sales sourced to the state.

Saxton & Stump's attorneys have worked with companies in nearly every state on each state's qualification for registering, filing, and, if necessary, negotiating with the individual state on a tax bill.

Q: Why haven't I heard of this tax before?

A: If you haven't heard of the nexus tax, you're not alone. Applying economic nexus to incomes taxes is still in its relative infancy, many states are still identifying all franchisors and businesses that qualify to pay it, and hundreds of franchisors have likely not yet been billed.

But when it does find a franchisor that qualifies to pay the tax, it doesn't start billing based on the identification of eligibility. The state will likely look back to when that particular state implemented its economic nexus standard. In Pennsylvania, the Department of Revenue began to require taxpayers without a physical presence who meet or exceed the $500,000 threshold to file Corporate Tax Reports for periods beginning on or after January 1, 2020.

Q: Why are states cracking down now?

A: Governments across the country are continually looking for new revenue streams. For states with the nexus tax, the cost of administering the identification of businesses that should be paying the tax is far less than the tax that would be collected, making it a viable and profitable revenue stream.

Q: My company/franchise has never been assessed for the nexus tax, but we've decided it's best to pay it now. What should we do?

A: The first thing you should do is consult with a tax attorney or tax professional to make sure your company meets the economic nexus requirements in any particular state. The attorneys in the Saxton & Stump Tax and Tax Controversy Group have helped dozens of businesses make this determination, including advising companies that they don't meet the economic nexus requirements.

If your company qualifies, the primary option in most other states is to apply to its Voluntary Disclosure Program. Voluntary disclosure programs are specifically designed for businesses and individuals who have recently become aware of their tax obligations. The programs allow the taxpayer to voluntarily come forward to resolve their tax issues and often forgive some taxes, interest and/or late penalties.

Q: If the state hasn't assessed me yet, why should I register and pay thousands of dollars in current and back taxes?

A: If (or perhaps when?) a state identifies a business that hasn't been paying the nexus tax, it will likely look to collect all back and current taxes owed and won't be as willing to accept a negotiated compromise amount.

For companies that do business in multiple states, once one state finds you, it's likely all the other states will as well. Dealing with tax investigations from multiple states simultaneously is not ideal.

Q: Beyond fines and penalties, could there be future ramifications for not paying the nexus tax?

A: Yes. If you have any plans to sell your business or franchise, even as part of a future succession plan set up before the nexus tax even existed, a very simple due diligence report will find the delinquent nexus tax. Depending on the amount owed, the nexus tax attached to the business could potentially kill any deal before it happens or until the nexus tax and all state obligations are paid in full.

The bottom line is that the nexus tax is real, and states are cracking down to identify what businesses should be paying it. With back taxes, the bill could potentially reach tens of thousands of dollars that businesses never budgeted for.

The Saxton & Stump Tax and Tax Controversy Group has worked with clients on tax regulations across the country, including nexus tax issues, and can help businesses determine their liability, negotiate a settlement, or dispute a tax bill they believe is incorrect. If you have questions about a nexus tax bill or possible qualification, please contact me or any member of the Saxton & Stump Tax and Tax Controversy Group.

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