MULTISTATE TAXATION – ISSUES AND PLANNING OPPORTUNITES

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Today's Instructor

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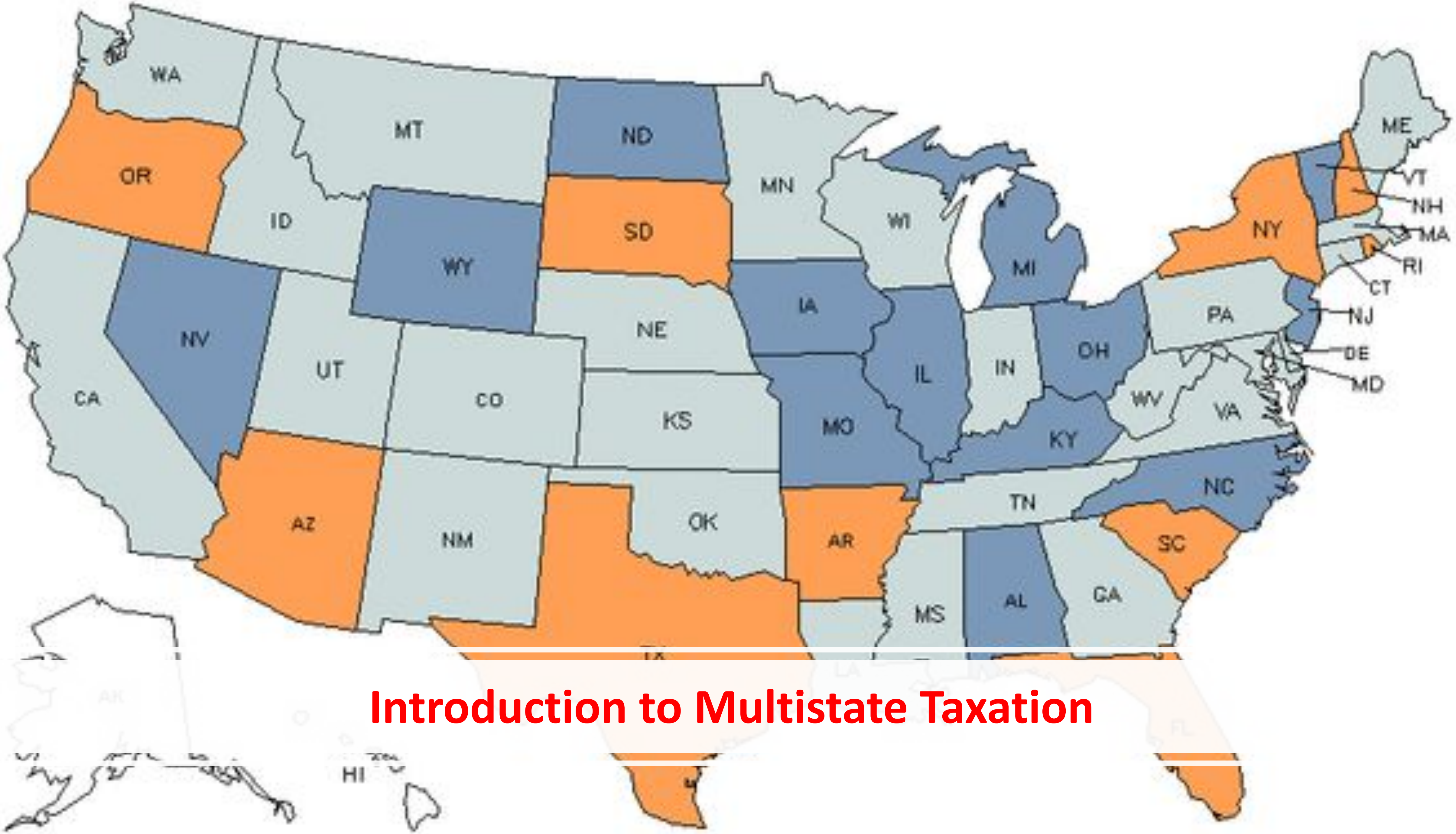

Introduction to Multistate Taxation

Introduction

- Many American taxpayers (humans and business entities) must pay tax bills to more than one jurisdiction.
    - This is because federal, state, and local governments are all empowered to levy taxes.
- Certain taxpayers face unique tax challenges by virtue of the fact that they live and work in different jurisdictions, or because they employ people who live in different states.
- Those with financial interests that cross state lines are responsible for fulfilling the respective tax obligations of each jurisdiction in which they do business.

Income in Multiple States

- Income derived from activities in one state may trigger tax liability regardless of the taxpayer’s domicile.
    - However, because of a constitutional prohibition on double taxation by multiple states on the same income, taxpayers earning income in multiple states must carefully account for what they owe to each jurisdiction in which they earned revenue.
- Tax liability may depend on any of several factors, including in which state the taxpayer earned money and whether the visiting jurisdiction has a relevant compact or agreement in place with the taxpayer’s home jurisdiction.

Individual Income Issues

- States have divergent standards regarding what triggers personal income tax liability for non-residents.
- However, common standards have developed across several jurisdictions.
- One common standard is the “first day” rule.
  - Under the “first day” rule, a taxpayer who works even for one day in a state in which he or she does not live owes income tax to that state.
  - Most states follow the first day rule, which means that most nonresident employees are subject to income tax liability if they earn any amount of taxable compensation in the state.

Individual Income Issues (cont.)

- A less-common standard (for states that do not follow the “first day” rule) regarding income tax liability for nonresidents is based on how long the person worked in the state.
    - These jurisdictions begin to impose non-resident income tax liability at time periods ranging from ten days to two months of work in a state.
- Some states assess income tax liability on an income-earned basis, meaning that taxes are collected once a nonresident earns a threshold amount.
- States are empowered to levy and collect taxes within its jurisdiction.
    - However, Congress has attempted to pass a set of federal laws designed to regulate the complicated processes for determining tax obligations in the context of multistate taxation issues.

Multistate Corporate Income Tax

- Businesses that operate in multiple states can incur corporate income tax liability in several jurisdictions.
  - Because most large corporations conduct business in more than one state, many businesses face tax obligations in multiple jurisdictions.
  - This has raised issues in administering state corporate income taxes that policymakers are still working to address.
- Some jurisdictions require corporations to divide taxable profits into in-state and out-of-state portions through an apportionment process.
  - However, not all states use the same apportionment schemes, and whether a business is subject to the tax laws of a particular jurisdiction depends upon whether the company has a “nexus” to the state.

Multistate Sales and Payroll Taxes

- For many businesses, whether a tax connection (nexus) exists proves difficult to determine.

- While the Supreme Court has delineated the baseline requirements for a nexus, each state has its own rules regarding what constitutes a business presence sufficient enough to trigger tax liability.

- This lack of consistency raises particular challenges for businesses that serve customers across many jurisdictions, such as internet wholesalers and retailers.

Multistate Sales and Payroll Taxes (cont.)

- In the landmark case of *South Dakota v. Wayfair,* the Supreme Court affirmed that state and local sales taxes may be assessed against out-of-state business that ship to in-state customers so long as these laws are written in a manner that prevents an unnecessary burden on interstate commerce.

  - *Wayfair* allows state and local governments to tax sales from companies located out of state only when compliance with the applicable tax rules are simple enough to not place an improper burden on interstate commerce.

Multistate Sales and Payroll Taxes (cont.)

- A corporation is responsible for withholding payroll taxes in the state where work is performed by the employee.
  - This is a state-specific responsibility.
  - Employees who work in a state trigger payroll and withholding regulations in that state, regardless of where the employer is located.
  - Thus, much like corporate income tax, businesses that employ workers in more than one state must apportion their tax liability.

Multistate Sales and Payroll Taxes (cont.)

- The Uniform Division of Income for Tax Purposes Act determines this apportionment based on a payroll factor ratio that balances payroll within the state against the company's total payroll.
  - The payroll factor includes wages, salary, commissions and other compensation. Other factors pertaining to the employee's residence, the amount of time an employee spends working in another state and the company's location are also considered.
  - However, if an employee spends time in multiple states, then the computations get more complicated.

Identifying and Handling Multistate Tax Issues

Introduction

- The seasoned tax practitioner must understand how to manage individual and multistate tax compliance issues.

- State tax departments are becoming smarter and more aggressive.

- Many companies are starting to reexamine their state tax compliance, or the lack thereof, and are looking for ways to identify and resolve multistate issues.

Identifying Multistate Issues

- Usually helping to identify a company's potential multistate tax issues starts with questions about nexus.

- A state's ability to impose its tax obligations on an out-of-state corporation (whether those obligations be for corporate, sales, franchise, or other taxes) is limited by the U.S. Constitution and may be further limited by federal and state laws.

- The nature and frequency of contacts that an out-of-state corporation must establish in a state before the corporation may be subject to that state's taxing jurisdiction generally is referred to as nexus.

Identifying Multistate Issues (cont.)

- Literally, the term "nexus" means connection.

- For state tax purposes, the term nexus is used to indicate that the connection between an out-of-state corporation and the taxing state is sufficient to allow the state to impose tax collection responsibilities over that corporation.

- **We will define and discuss the term "nexus" thoroughly later in this program.**

Identifying Multistate Issues (cont.)

- The principal provision that limits states' jurisdictional powers to impose tax responsibilities on an out-of-state corporation is the commerce clause of the U.S. Constitution.
  - The commerce clause provides: "Congress shall have power . . . to regulate commerce with foreign nations, and among the several states, and with the Indian tribes.“
  - Though phrased as a grant of regulatory power to Congress, the clause has long been seen as a limitation on state regulatory powers, as well.
    - That interpretation denies states the power to unjustifiably discriminate against or burden the interstate flow of articles of commerce. In *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), the Supreme Court enunciated the modern four-prong commerce clause test that is used to determine whether a state tax is constitutional.
      - The first prong of this test requires that a state tax must be applied to an activity that has a substantial nexus with the taxing state.

Determining Applicable Taxes

- But even after nexus is determined, and before decisions are made about compliance, questions have to be asked about whether and to what extent a company even has a tax liability.
  - Usually, practitioners generally should be concerned with responsibility for four separate business tax types:
    - Payroll tax (including employee responsibility for individual income tax);
    - Corporate income tax;
    - Corporate franchise tax; and
    - Sales taxes.
- Not all states impose every tax type, and not every company will have responsibility for all taxes.

Determining Applicable Taxes (cont.)

- **For example:** International companies often make the mistake of assuming that their protection from federal-based taxes under some form of treaty involving the United States and other countries also protects them from state-based taxes.

Determining Applicable Taxes (cont.)

- None of those treaties, however, include states as parties.
  - No state has a treaty regarding taxes in place with a foreign country.
  - That said, special rules may apply in some states that would exempt a federally exempt company (or employee) from state taxes.
  - If a company's employees are not subject to U.S. federal tax, it is possible that they would be similarly exempt from state taxes. That is because most of the states use federal adjusted gross income as the starting point for the determination of personal income taxes. Thus, if an employee is exempt from federal taxes and therefore has no federal taxable income or AGI, he or she similarly would have no state taxable income by virtue of the state's computational rules. The same analysis could apply in the corporate income tax context.
  - States that use federal taxable income as their starting point could provide protection for companies that have no federal taxable income due to a treaty.

Resolving a Multistate Tax Problem

- Due to the fact that many states take an aggressive position regarding nexus and taxability issues, SALT practitioners are often bearers of bad tidings.

- Fortunately, there are a variety of ways for companies to quickly and safely address multistate tax concerns.

- Some companies consider "prospective" compliance the best option.

  - That obviously is sufficient to ensure compliance in the future, but it leaves open the possibility of investigations or audits for previous periods.

  - That can especially be a problem, given that questions on the registration forms the company will have to fill out in the state ask "why are you registering?" and/or "how long have you been here?“

  - Those questions can be difficult to answer if there are past issues.

Resolving a Multistate Tax Problem (cont.)

- Other companies often consider, particularly in the international cross-border context, the creation of a new legal entity, generally formed in the United States, to handle all U.S. operations on a going-forward basis.
  - The idea behind that compliance strategy is to engage in business in a new, untainted entity, with the obvious goal of avoiding issues in earlier years that may exist with the old company.
  - This approach is sufficient to address going-forward concerns, and it also makes it a lot easier to fill out that initial registration form.
  - However, it still leaves the company open to audits and investigations for previous years' taxes.

Resolving a Multistate Tax Problem (cont.)

- Finally, through the Streamlined Sales Tax Project, many states are offering amnesty to taxpayers that are willing to participate in the project on a going-forward basis.

  - Although that amnesty is available only in participating states and participation could create other issues and problems that have to be considered for particular taxpayers, the benefit of the amnesty program is that it requires compliance only on a going-forward basis.

  - Participating taxpayers are absolved of all previous years' tax responsibility, at least for sales tax purposes.

Nexus

Introduction

- Every company that operates in multiple states has the potential to have nexus issues in each state in which it is not filing an income tax return.

- Nexus is a connection between a taxpayer (such as a corporation, an S corporation or a partnership) and a taxing jurisdiction that is constitutionally and statutorily sufficient enough for the taxing jurisdiction to impose on the taxpayer a tax (such as an income tax) or an obligation to collect a tax (such as a sales tax).

Basics of Computing State Income Taxes on a Multistate Company

- To appreciate the role of nexus in the context of state income taxes, it is helpful to review the basics of taxing the income of companies that operate in multiple states.

- Most states impose income tax on a company's income in either one of two ways, which mostly depends on the type of company it is.

  - On the company directly (which is the most common way of taxing a C corporation); or

  - On the income passed through to the owners of the company (which is the most common way of taxing a pass-through entity such as a S corporation, partnership, limited liability company taxed as a partnership).

- In the latter instance there is an additional issue of whether the state has nexus with the pass-through entity's owners by virtue of their ownership interests.

Basics of Computing State Income Taxes on a Multistate Company (cont.)

- When a company operates in and has nexus in only one state, that state will generally seek to apply its tax to all of the company's income.

- When a company operates in and has nexus with multiple states, each state will seek to tax some portion of the company's income, which is determined using an apportionment formula.

  - In this regard, a company's income can be thought of as a pie and the apportionment formula as the method for determining each state's slice.

  - Most states' apportionment formulas are somewhat similar and somewhat different at the same time due to the fact that these states have adopted the Uniform Division of Income for Tax Purposes Act of 1957 ("UDITPA") or patterned their income tax laws after UDITPA and then modified it.

Basics of Computing State Income Taxes on a Multistate Company (cont.)

- The formula UDITPA uses to apportion business income is an average of three ratios:
  - Property in the state divided by property everywhere;
  - Payroll in the state divided by payroll everywhere; and
  - Sales in the state divided by sales everywhere.

Basics of Computing State Income Taxes on a Multistate Company (cont.)

- Many states have modified the formula.
  - As an example, some states more heavily weight the sales factor.
  - Several states have taken this to the extreme by eliminating the property and payroll factors altogether and adopting a single sales factor.
- The apportionment factor is multiplied by a company's income to determine what portion of that income is subject to tax by the taxing state, which must have the requisite nexus to impose that tax.

Statutory Nexus vs. Constitutional Nexus

- A state's income tax statutes must apply to impose tax on a company.
- The United States Constitution sets limits on how far a state's nexus statutes can reach.
- The Due Process Clause requires a minimum connection, and the Commerce Clause requires a substantial nexus.
- The United States Supreme Court last addressed the issue of nexus, in a sales and use tax case, Quill Corporation v. North Dakota, in 1992. Quill requires a nexus in the form of the taxpayer having at least a physical presence, i.e., property or payroll, in the taxing state.

Statutory Nexus vs. Constitutional Nexus (cont.)

- Congress can and has exercised its powers under the Commerce Clause to limit states' authority to impose income taxes.

- Public Law 86-272, 15 U.S.C. §§381 to 384, prohibits a state from imposing an income tax provided that the only business activities within that state are limited to the solicitation of orders from customers and prospective customers for sales of tangible personal property that are sent out of state for approval or rejection and if approved, are filled by shipment from a point outside the state.

Nexus Trends

- One relatively recent trend is for states to take the position that for income tax purposes, a physical presence in the state (à la Quill) is not necessary for nexus.
  - Rather, nexus can be based on directing activities at customers in the state.
  - This is often referred to as economic nexus. For example, in Capital One Bank v. Commissioner of Revenue (Mass. 2009), the Supreme Judicial Court of Massachusetts held that an out-of-state bank issuing credit cards to Massachusetts residents had nexus with that state.
- Another developing trend is for states to enact so-called factor threshold nexus statutes.
  - Under such a scheme, a company would have nexus if it had property, payroll or sales that exceeded the statutory threshold such as $50,000 in property or payroll or $500,000 in sales or a taxing state sales factor of 25% or more.

Nexus Trends (cont.)

- Nexus issues come up both in the sales tax and income tax contexts, and generally the rules are similar.
- In the sales tax area, liability tax collection is premised on nexus.
- New York's Court of Appeals also has indicated that while physical presence is required, it need not be more than the "slightest presence.“
- Similarly, other Supreme Court cases indicate that the type of physical presence necessary to create sales tax nexus may be as slight as a temporary presence in the state of the corporation's property or personnel, and that any contact with the taxing state beyond the mails or common carrier may give rise to sufficient nexus.

Nexus Trends (cont.)

- Cases to note:
  - In *Felt and Tarrant Co. v. Gallagher*, 306 U.S. 62 (1939), two soliciting sales agents and a rental office in the state created sufficient nexus.
  - In *Standard Steel Co. v. Washington Revenue Dept*., 419 U.S. 560 (1975), one resident employee operating out of his home in the taxing state created sufficient physical presence.
  - In *National Geographic*, 430 U.S. 551 (1977), two business offices unrelated to the taxpayer's sales activities within the state created sufficient physical presence.

Analyzing and Resolving Nexus Issues

- One approach to analyzing nexus issues is to examine a company's contacts (or lack thereof) with a state.
  - This can be done by reference to a state nexus questionnaire.
- Also, because apportionment determines how much income is apportioned to a state for income tax purposes and the traditional apportionment factors are often indicative of the potential for activity in a state, this same information can be used to gauge the potential for nexus issues as well as their scale and scope.
  - In this regard, it can be helpful to review the states in which a company has property (owned and rented), payroll (especially unemployment wages) and sales (where the company's customers are and to where its products or services are delivered).

Analyzing and Resolving Nexus Issues (cont.)

- Tax practitioners are often left with their predecessors' determinations regarding nexus.
- Problem: What do you do when you discover a potential nexus issue?
  - First, quantify it.
  - Next, analyze it to determine and provide support for the basis for the company's position.
- If it is determined that the company has or may have nexus with a state or multiple states in which tax returns were not filed, consider resolving it via a voluntary disclosure program, which many state departments of revenue offer. It is often best to do this anonymously through tax practitioner.
- Amnesty programs authorized by statute are another option, though these are only available sporadically when enacted by the applicable state legislature.

Calculation of State Taxable Income

Introduction

- As previously discussed, multistate income taxation is an issue that affects many companies (some of whom probably fail to realize it).

- Unlike small and medium size companies doing business in the private sector, it is not at all unusual for a company to perform contracts in more than one state.

Example

- Ace Contractors, Inc., (“ACE”), a Virginia corporation, has been performing on a company for the past five years using employees located at their Virginia headquarters as well as at a Federal installation in Arizona. Historically, ACE has filed income tax returns only in Virginia. Recently, ACE received a questionnaire from the Arizona taxing authorities inquiring about their operations in that state. After returning the questionnaire, ACE got word from Arizona that the state has determined ACE to be subject to Arizona taxes on a portion of the Company's earnings.

Problems

- Since ACE has failed to file the required tax returns with the state of Arizona, the unfortunate result is that ACE is now liable for interest and penalties for both failure to file and failure to pay as well as the unpaid income taxes.

- In addition, ACE is in a Catch-22 situation as a result of the provisions governing the statute of limitations.

  - Ideally, ACE would act to amend it’s Virginia income tax returns for the past five years to reflect the reduced income apportionable to Virginia as a result of Arizona's claim.

  - However, since ACE filed timely returns in Virginia, the statute of limitations has expired on the earlier returns and thus only the last three years' returns may be amended.

  - In Arizona, where ACE has never filed, the statute of limitations has not begun to run.

  - Therefore, ACE will have to pay double state taxes on the income earned during the lapsed statute issue.

Multistate Tax Exposure

- To determine if a corporation is subject to a state's income tax, the state will determine if a company has "nexus" within that state.
  - As previously discussed, nexus can be defined as sufficient contact within a state to require the filing of an income tax return.
  - Although nexus is defined on a state-by-state basis, certain activities or circumstances usually guarantee that nexus exists. Generally, nexus is present in the following situations:
    - Domestication within a state;
    - Having legal domicile or a principal place of business within a state;
    - Employment of capital or property within a state;
    - Maintaining an office or other facility within a state;
    - Rendering services within a state; and
    - Solicitation of orders within a state.

Multistate Tax Exposure (cont.)

- Federal Law PL 86-272 bars states from claiming nexus if the only contact within the state is limited to the employment of salespersons or independent contractors whose only function is to solicit sales for out of state approval and fulfillment.
    - This very limited exception dramatically restricts the activities of the salesperson or agent.
    - In fact, in order to comply, all decisions and customer support must be handled outside the state in which the salesperson operates.
- Given the current budget crisis, states are aggressively searching for new sources of revenue, and in many cases, companies stand out as easy targets.
    - Finding delinquent tax filers is often as simple as matching payroll, sales or property tax forms against required income tax filings. For example: Many contractors who deny or ignore the existence of nexus within a state nonetheless file payroll, sales or property tax returns, as applicable.
    - If the state fails to find a match it will usually begin an investigation of the entity in order to discover whether a reason exists for the failure to file.

Multistate Tax Apportionment

- States must fairly allocate or apportion the income between themselves.
- Apportionment is defined as the process by which entities divide their income between two or more states.
- Although each state has its own method of apportioning income, most states use a variation of the three-factor formula.
  - The three factors normally used to apportion income are gross receipts, property, and payroll.

Multistate Tax Apportionment Example

To illustrate the three-factor formula, consider the following illustration for Ace Contractors, Inc., based on federal taxable income of $50,000 for the current year:

	Total	Virginia	Arizona
Gross receipts	$500,000	$400,000	$100,000
Payroll	$200,000	$100,000	$100,000
Property	$300,000	$200,000	$100,000

Multistate Tax Apportionment Example (cont.)

- The apportionment factor for Arizona would be calculated by dividing Arizona gross receipts, payroll, and property each by total gross receipts, payroll, and property, respectively. The three factors would then be summed and divided by three to calculate the Arizona apportionment factor as follows:

100,000/500,000 + 100,000/200,000 + 100,000/300,000 = .34 or 34%

- Arizona's apportioned taxable income is $17,000 ($50,000 * 34%). Conversely, Virginia's apportioned taxable income is $33,000 ($50,000 * 66%).

Tax Planning Opportunities

- States have different tax rates and apportionment methods which gives rise to significant tax planning opportunities.
  - For instance, some states do not impose state income taxes at all, while certain others have relatively low rates.
  - If a company can allocate income to such states, significant tax savings can be obtained.
- Using our Ace Contractors, Inc., example whereby ACE is contemplating moving corporate headquarters and starting a sales force:
  - To evaluate the potential state tax consequences, ACE would first look at the taxes (payroll, income, sales, franchise, etc.) imposed by the various states under consideration and the associated tax rates.
  - In addition, ACE would evaluate the income tax apportionment factors for each state and consider the likely tax impact.
  - By calculating the taxes for each possible situation, ACE could minimize their state tax costs.

Filing Methods

Introduction

- If a corporation is, by itself or as a member of an affiliated group, doing business in more than one state, the tax practitioner must not only grapple with questions of nexus, but also the methodology for determining the taxpayer's tax base.

- In other words, for any specific state, we must determine if we are filing separate company returns, a consolidated return or a "combined" or "unitary" return.

Separate, Consolidated, or Combined Filing

- "Separate Filing" defined:
  - Each company with nexus in the state must file its own separate return, regardless of whether it is part of an affiliated or consolidated group.
- A number of states that allow only separate filing, that is, each and every company with nexus must file a separate return.
- It is irrelevant whether the corporation is a standalone entity or a member of a controlled, affiliated or consolidated group.

Separate, Consolidated, or Combined Filing (cont.)

- Those states requiring separate filing include Alabama, Arkansas, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Mississippi, Missouri, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee and Virginia.
  - In these states, consolidated or combined filing is generally not allowed.
  - That said, there may be a trend toward combined reporting.
  - These states have adopted combine reporting: Massachusetts, Michigan, New York, Texas, Vermont and West Virginia.

Example: New York

- New York is an example of the recent move of some states toward combined filing. New York has traditionally been a separate filing state, but it provided for combined reporting when three factors were present:
    - Common ownership (80%);
    - A unitary business (the companies generally had to be in the same line of business, either vertical or horizontal integration); and
    - That the failure to file a combined report would lead to “distortion.”

Example: New York (cont.)

- Distortion was presumed to exist where there were “substantial” (defined as 50 or more) “intercorporate transactions” (a company’s receipts or expenses).
- In short, separate filing was the default, but combined filing was a possibility if it more accurately represented a taxpayer’s income.
- Not surprisingly, there was significant disagreement over what constituted “distortion.”

Separate, Consolidated, or Combined Filing (cont.)

- Separate filing has both advantages and disadvantages.
  - The most obvious disadvantage is that a company is prohibited from offsetting profitable subsidiaries with subsidiaries with losses.
  - However, separate filing states offer advantages when a multistate taxpayer can arrange its legal structure to isolate high-profit margin activities in low- or no-tax states and its low-profit margin activities in states with higher tax rates.
  - For example, isolating a company's sales and marketing functions from its manufacturing activities and conducting each in separate companies may allow shifting of income from high- to low-tax states.

Separate, Consolidated, or Combined Filing (cont.)

- The majority of states, while allowing separate filing, will also permit consolidated filing if certain requirements are met.
- To elect consolidated filing, most states require the same stock ownership requirements (80%) as that of the federal consolidated rules.
- In addition, a state may require that only the affiliated entities that have nexus with the state be part of the consolidated return, that is, a “nexus-consolidated” return.
- Consolidated filing may also be allowed or even required when separate filing does not fairly reflect a company’s income or economic activities.
    - Connecticut, Indiana, Mississippi and Tennessee, for example, are generally separate filing states, but they will permit or require consolidated or combined filing when necessary to properly reflect income.

Separate, Consolidated, or Combined Filing (cont.)

- Example:

- **Take three corporations: a parent and two wholly owned subsidiaries. The Parent files a federal consolidated return with its subsidiaries. The Parent and Sub One are both doing business in and have nexus with State X. Sub Two does not have any employees, property or sales in State X. It is not doing business in State X and, accordingly, does not have nexus with the state. Each company's income and state apportionment factors are as follows:**

Separate, Consolidated, or Combined Filing (cont.)

- Combined reporting requires the members of a "unitary" group to calculate their taxable income on a combined or "unitary" basis.

- The combined or "unitary" reporting states include Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, Wisconsin and West Virginia.

Corporation	Nexus In State X	Taxable Income	State X* Numerator	State X* Denominator	Apportionment Factor	Separate Filing	Consolidated Filing	Combined Filing
Parent	Y	300	40	400	10.00%	30	–	–
Sub One	Y	200	20	500	4.00%	8	–	–
Consolidated Total		500	60	900	6.67%	–	33	–
Sub Two	N	100	0	100	0.00%	–	–	–
Combined Total		600	60	1000	6.00%	–	–	36

Separate, Consolidated, or Combined Filing (cont.)

- Separate Filing:

Parent: 300 x 40/400 = 30
Sub One 200 x 20/500 = 8
Total taxable income 38

If State X allows only separate filing, the Parent and Sub One will each file a separate return, including only their own separate income and factors. Sub Two will not file a return in State X, because it is not doing business in State X and does not have nexus with the state.

Separate, Consolidated, or Combined Filing (cont.)

- Consolidated Filing:

Parent and Sub One 500 x 60/900 = 33 (nexus only)

If State X allows the filing of consolidated returns, but only among companies that have nexus with the State, the Parent and Sub One combine their respective income and apportionment factors to arrive at state taxable income. Again, because Sub Two does not have nexus with State X, it cannot file as part of the consolidated return.

Separate, Consolidated, or Combined Filing (cont.)

- Combined Reporting:

Parent and Sub One 600 x 60/1000 = 36

If State X allows or requires combined reporting, then the income and apportionment factors of all the affiliated companies are summed to calculate the state taxable income for the Parent and Sub One. There are several key points to be noted. First, the income and apportionment factors of Sub Two are included in the calculation even though Sub Two is not doing business in State X and does not have nexus with the state. Second, combined reporting is not a return, per se, but a method for calculating the state taxable income of a "unitary" or "combined" group.

South Dakota v. Wayfair, Inc.

Introduction

- On June 21, 2018, the U.S. Supreme Court decided South Dakota v. Wayfair, Inc. in favor of South Dakota's imposition of sales tax collection obligations on remote sellers meeting economic thresholds based on in-state receipts or transaction volume.

- In this landmark decision, the Court overturned the "physical presence" requirement for sales tax nexus set forth in National Bellas Hess, Inc. v. Department of Revenue of Illinois in 1967 and subsequently affirmed in Quill Corp. v. North Dakota in 1992.

Impact of Wayfair Decision

- **Widespread adoption of sales tax economic nexus laws**
  - Post-Wayfair, states and localities began enacting sales tax economic nexus laws and issuing guidance similar to South Dakota's.
  - In fact, in anticipation of the Wayfair decision, some states had laws in place or on hold that were in direct conflict with Quill; thus, once the Supreme Court ruled, those states could begin enforcing economic nexus.
  - As of January 1, 2023, all states with a sales tax had enacted sales tax economic nexus.

Impact of Wayfair Decision (cont.)

- **Economic nexus examples:**
  - Beginning effective dates range from June 21, 2018, in New York to Jan. 1, 2023, in Missouri.
  - A dollar or transaction threshold may trigger nexus in some jurisdictions, such as Georgia and Kentucky, while a dollar and transaction threshold has to be met to trigger nexus in others, such as New York and Connecticut. Further, many states, such as Washington and Wisconsin, have only a dollar threshold.
  - Sales made through marketplace facilitators are included in economic nexus thresholds in some jurisdictions, such as California, and excluded in others, such as Florida.
  - The period in which the economic nexus standard applies can be the prior calendar year, such as in Michigan; the prior or current calendar year, as used by Hawaii; a rolling 12 months, as adopted in Tennessee; or other period.

Impact of Wayfair Decision (cont.)

- **Economic nexus examples (cont.):**
  - Dollar thresholds range from $100,000 to $500,000 and vary in their composition among gross sales, taxable sales, and sales of tangible personal property.
    - Moreover, taxability of products and services varies by state, and states define tangible personal property differently.
    - For example, California's and New York's economic nexus laws both specify that only tangible personal property is included in the economic nexus threshold.
    - However, if asked whether electronically downloaded software qualifies as tangible personal property, California would say no but New York would disagree.

Impact of Wayfair Decision (cont.)

- **Economic nexus examples (cont.):**
  - The definition of a “transaction” has indeed been challenging for taxpayers and has resulted in unexpected consequences.
  - Taxpayers with high-volume but low-dollar sales could have minimal revenue in a state but still be required to comply because of a transaction count threshold.
  - In light of this unexpected complexity and states’ concerns about the repercussions of enforcement, a positive trend has been an elimination of the transaction count threshold in an increasing number of states.

Impact of Wayfair Decision (cont.)

- **Economic nexus is not limited to state sales tax**
  - One typically hears that 45 states and the District of Columbia impose a sales tax.
    - In reality, 45 states and many localities impose and administer their own sales taxes.
    - The latter include the District of Columbia and, for example, 300+ localities in Alabama, 70+ localities in Colorado, 60+ parishes in Louisiana, and 100+ localities in Alaska.
    - In the sales tax world, localities in states that allow for the local administration of sales tax are collectively referred to as the home rule jurisdictions.

Impact of Wayfair Decision (cont.)

- **Economic nexus is not limited to state sales tax (cont.)**
  - Given South Dakota's centralized administration of sales tax, locally administered sales taxes were not addressed as a part of the Wayfair decision.
  - In the years after the decision, discussions and predictions concerning the imposition of economic nexus on locally administered sales taxes progressed from whether it would happen to when and how.
  - Five years later, as a result of Wayfair and the powers some states give localities, many home rule localities have implemented sales tax economic nexus.

Impact of Wayfair Decision (cont.)

- **Fundamental questions remain**
  - Six years after the Wayfair decision, sales tax collection and remittance requirements for remote sellers and marketplace facilitators have been adopted by all states that impose a sales tax.
  - However, uncertainties over such foundational questions as who bears the burden of collecting and remitting tax, to what products taxes apply, and what transactions are covered exist.
  - Sales and use tax complexity is attributable at least in part to the U.S. federal-state system of government, allowing the "laboratories of democracy" to reflect their own policy decisions in their disparate tax laws.

Multistate Tax Planning – S Corporations

S Corporation Multistate Issues

- Many S corporations do business in multiple states and must file income or other tax returns in them.

- Many states have been more aggressive in going after out-of-state companies doing business in their states.

- Many of these businesses do not realize they have an exposure to a state’s taxes until they receive a nexus questionnaire from that state.

- For CPAs and EAs, the growth and expansion of these businesses create opportunities for additional tax compliance and tax planning services.

- States differ as to whether they recognize the S corporation as an entity for tax purposes, the method of electing S status, types of taxes assessed, apportionment formulas applied and other issues.

S Corporation Income Apportionment

- Multistate S corporations are allowed to apportion their income to the states with which they have nexus.
- For many years, most states followed an evenly weighted three-factor apportionment by sales, tangible property and payroll in each state.
- Recently, states have been changing their apportionment formulas.
  - The trend has been for states to assign a greater weight to the sales factor and less or no weight to property and payroll.
  - Thus, states can shift the tax burden from in-state corporations to out-of-state corporations, which are less likely to have property in the state or pay workers there.

Audit Defense

Multistate Travel Issues

- When an employer conducts business in multiple states, income taxes may need to be withheld in each of those states.

- An employer needs to identify which state they consider their resident state, which is where they live and work.

- Employers who do business in both their home state and in another state can see if each state has a reciprocal agreement available for tax purposes.

Reciprocal Agreement Issues

- Reciprocal agreements were enacted to ensure a smooth process for employers by allowing them to only withhold in one state.

- If a person works anywhere other than their home state, they will be subject to paying state taxes in all states they have traveled for business.

- Multi-state audits start by creating efficient audit systems where states delegate different groups to start the examinations.

Reciprocal Agreement Issues (cont.)

- The audit programs abide by specific tax laws and typically apply to taxpayers who:
  - Have large intercompany transfers;
  - Do not accurately report;
  - Have apportionment that changes annually; or
  - Have an excessive amount of Federal income.

Multistate Tax Commission

- The Multistate Tax Commission is an intergovernmental state tax agency working on behalf of states and taxpayers to facilitate the equitable and efficient administration of state tax laws that apply to multistate and multinational enterprises.

- Created by the Multistate Tax Compact, the Commission is charged by this law with:

    - Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
    - Promoting uniformity or compatibility in significant components of tax systems;
    - Facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and
    - Avoiding duplicative taxation.

Multistate Tax Commission (cont.)

- With the Multistate Tax Commission growing sterner in their guidelines, it is in the taxpayer’s best interest to stay in compliance.
    - They can do this by performing SALT reviews to see if they need to file in multiple states and if they are on the right track to passing audits.
    - The overall objective of the SALT review is to limit potential exposure to unsettled tax liabilities.

Sales Tax Audits

- For most sales tax audits, the auditor is looking for two things:
  - Taxable sales that were not property taxed; and
  - Taxable purchases that were not taxed.
- The variations on this basic rule vary by business and industry.

Sales Tax Audits (cont.)

- The following is a list of the common issues found in sales tax audits:
  - Missing exemption certificates for untaxed sales;
  - Sales made to non-profit organizations that seller believed to be exempt but are not;
  - Not charging tax on shipping charges are required;
  - Not charging tax on other services as required by law;
  - Failure to tax bundled transactions according to state law;
  - Failure to pay use tax on untaxed purchases used by your business and not resold;
  - Payment of additional local tax when purchases are consumed in multiple local jurisdictions;

….continued on next slide

Sales Tax Audits (cont.)

- The following is a list of the common issues found in sales tax audits (cont.):
  - Failure to have proper documentation to support non-taxable purchases such as downloaded software and other digital products;
  - Failure to have receipts to support charges made on credit cards to show where purchase occurred and that tax was charged;
  - Improper or unclear invoices that don’t accurately portray the sales transaction;
  - Operating and capital leases that are not taxed properly; and
  - Intercompany transactions that are not properly taxed or documented.

Resource

- The following is a link to the Multistate Tax Commission website:

https://www.mtc.gov/

Domicile Planning

Tax Cut and Jobs Act of 2017

- Made domicile planning more important due to :
  - Limitation on state and local income tax deduction to $10,000
  - Limitation on home mortgage interest deduction to interest on $750,000 of acquisition indebtedness

The State Attitude

- States do not see the “humor” in domicile planning
- Certain States are aggressive in what they see as their right to enforce domicile
  - California
  - New York

The Effect of Domicile on Estate and Financial Planning

- Domicile Defined - **"A fixed, permanent, and principal home to which a person, wherever temporarily located, always intends to return"**

Significance of Domicile

- Disposition of Property
- Appointment of Fiduciaries
- Impact of Death Taxes
- Asset Protection Issues

Types of Domicile

- Domicile of Origin
- Domicile of Choice
- Domicile by Operation of Law

Domicile Planning Checklist

- Residence
- Registration
- Banking
- Memberships
- Credit Accounts
- Securities

Domicile Planning Checklist (cont.)

- Personal Property
- Wills and Testamentary Interests
- Other Legal Documents
- Taxes

Contact Information

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