

TAXING MATTERS: YOUR CLIENT COULD OWE TAXES IN ANOTHER STATE — AND SAVE MONEY BY FILING THERE

By Keith Shaffer and Steven Plisko

Do you represent a company that owns or leases property outside of its home state? Does it conduct sales or operations in more than one state? Do members of its staff live in a state different from the one in which they work? If you answered “yes” to any of these questions, your client could owe taxes in more than one jurisdiction.

Multistate income taxation affects many companies — and some do not even realize it.

Are you exposed?

The laws of each individual state control if a company is subject to its income tax by determining whether or not the company has a nexus — or a connection — with it.

Although nexus is determined on a state-by-state basis, certain activities or circumstances within a state usually guarantee it exists, including:

- Having legal domicile or a principal place of business;
- Maintaining an office or other facility, or owning property;
- Having payroll;

- Rendering services; and
- Soliciting orders.

The level of nexus required varies depending on the tax involved. The three most prevalent state taxes are: 1) corporate income, 2) franchise and 3) sales and use.

Income tax nexus is the term used to describe the types of contacts necessary to establish a state’s right to impose an income tax obligation. A corporation generally is subject to income tax in the state in which it is incorporated, and also may be subject to income tax in any other states in which its property, employees or other agents are physically present on a regular and systematic basis. A corporation which has income tax nexus in a state will also have nexus for franchise tax and sales tax.

Federal Public Law 86-272 prevents states from claiming income tax nexus if 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. However, Public Law 86-272 does not prevent states from claiming franchise tax or sales tax nexus when a corporation is soliciting sales within a state. Also, Public Law 86-272 only applies to solicitation of sales of tangible personal property. Solicitation of sales of services or intangible property are not afforded protection from imposition of an income tax.

Franchise tax is a tax that corporations pay for the privilege of doing business within the state. Depending on the state, the franchise tax may be levied based on percentage of profits, capital stock, net worth of the business, assets or the amount of property held within the state. It is not uncommon for a company to be subject to a franchise tax, but not an income tax, in the same state. Beginning in 2009, Massachusetts will require companies that do business in the state to pay either the franchise tax on net worth or tangible assets, even when Public Law 86-272 protects the company from income tax.

A business must collect sales tax from its customers when it has a direct or indirect physical presence in a state, known as sales tax nexus. Failure to recognize that sales tax nexus may exist in a state, even where there is no income tax nexus in that same state, can result in exposure for uncollected sales tax.

How can you reduce your overall state tax liability?

Establishing nexus with a state does not necessarily increase your tax liability. Take corporate income taxes: Many states determine the portion of your income subject to their tax using a three-factor apportionment formula based on the percentage of your sales, property and payroll attributable to the state. Others use a single-factor apportionment formula based just on sales.

States generally require a taxpayer to be subject to income tax in more than one state before they are allowed to apply an apportionment formula. When corporations are allowed to apportion



Keith Shaffer, CPA, is a principal with Braver PC, specializing in corporate and international taxation. He received his Bachelor of Science degree in Accountancy from Northern Illinois University.



Steven Plisko is a senior tax accountant with Braver PC, specializing in multi-state corporate taxation and sales and use taxation. He received his Bachelor of Science degree in Accountancy from Emmanuel College and Master of Science in Taxation degree from Bryant University.

their income, sellers of tangible property determine their sales factor by dividing the amount of sales delivered to customers in a state by total sales. Many states, including Massachusetts, have a sales “throw back rule” which can cause sales delivered into states where the corporation is not subject to tax to be included in, or thrown back to, the numerator of another state where the corporation is taxable.

Having nexus in another state may enable you to reduce your tax bill by apportioning some of your income to a state with a lower tax rate and reducing your apportionment in a higher tax rate state. For example, say your company is based in Massachusetts but makes substantial Internet and mail order sales in Florida, where it has no physical presence. Massachusetts’ business income tax rate is 9.5 percent, while Florida’s is only 5.5 percent. Both states apportion income using the same formula.

Assume your company’s taxable income is \$1.5 million. If your company has no nexus with any other state, all of its income will be taxed by Massachusetts, for a tax liability of \$142,500 (\$1.5 million x 9.5 percent). But if your company established income tax nexus with Florida, some of its income could be taxed at the lower 5.5 percent rate, reducing its overall tax bill. The portion of the company’s income subject to tax in Florida would not be subject to tax in Massachusetts.

A company will be considered to be taxable in another state only if that state has jurisdiction to tax the company, whether or not it imposes such a tax. If a tax return is not filed in another state, Massachusetts will presume that the company is not taxable in that state. A tax filing that is not required, but rather is made on a voluntary basis, will not be sufficient evidence to support that a

company is taxable in such other state.

Exactly how much tax could be saved would depend on a variety of factors. But given the fact that the Massachusetts Legislature may consider a proposal to increase the corporate tax rate to 10.5 percent, the highest rate in the country, any redistribution of taxable income from Massachusetts to another state will result in a reduced overall tax liability. Of course, before taking steps to establish nexus with another state, you would also need to consider the other potential business and tax consequences.

Are you in compliance?

Filing requirements for multistate corporations vary considerably from state to state. The requirements are further complicated when the company with nexus is a member of a group of affiliated companies. Some states require each taxpayer with nexus in the state to file a separate return, while others require or allow related taxpayers to report income on a combined or consolidated basis.

Businesses that sell, rent or lease a product collect and remit sales taxes to a variety of jurisdictions. In general, vendors who have made any sales that are subject to sales or use tax, and purchasers who are required to pay the use tax, must file returns on a monthly, quarterly or annual basis.

To avoid paying too high a tax bill or being exposed to penalties for not filing in required states, carefully consider state income tax and sales tax filing requirements in all states for which nexus potentially exists. Discussing your business’ interstate activities with your tax and legal advisors can help ensure you stay in compliance, and may in fact reduce your company’s overall state tax bill.