

State Taxes – What you need to know and what it means for your firm

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Today's Presenters



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Agenda and Objectives



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- Gain an understanding of nexus, apportionment and sourcing of revenues
- Examine the impact of telecommuters
- Overview of nonresident withholding and impact of composite returns
- Identification of other state issues
- Learn about recent state and local tax updates

- State and local governments continue to aggressively look for new revenue sources
- Generating revenue from non-residents (non-voters) is the least controversial
- Business and individuals are now often faced with tax liability in states and cities where they do not have an office and do not reside

The determination of whether a firm or an individual has a filing requirement or owes tax to a jurisdiction involves 3 steps:

1 Does the firm have nexus or sufficient contacts to be considered doing business?



2 If nexus exists, how is revenue sourced to that jurisdiction?



3 What is the method of apportioning income to the jurisdiction?



Nexus is the quality and quantity of business connections that must exist between a political jurisdiction and a taxpayer before the jurisdiction can impose a filing requirement for either sales or income tax.

...In simpler terms, Nexus = Presence.

Two tests that establish nexus:

- Physical presence (Historical approach)
- Economic presence (National trend)

Physical Presence

- Each jurisdiction has its own definition
- Some states only require contact for one day
- Real and personal property that is either owned or being rented will create a physical presence
- Attendance at a conference or meeting can create nexus
- Employees located within or performing services in a state

Economic Presence

- Generating revenue from clients located within the state (service-based business)
- Defined differently by the various states
- National trend is that states are moving to economic presence standard for nexus
- Most states have a subjective test, but the trend is toward a bright-line revenue test to determine nexus

CA: A taxpayer is doing business if any of the following are satisfied [CA Rev. & Tax. Cd. § 23101(b)]:

- Organized or domiciled in CA
- **Sales in CA > \$500,000* or 25% of total sales**
- Property in CA > \$50,000* or 25% total property
- CA compensation > \$50,000* or 25% total compensation

*Indexed for inflation

Economic Presence — Bright-line test

1. **California:** \$500,000 (*amounts are indexed for inflation*)
2. **Colorado:** \$500,000
3. **Connecticut:** \$500,000
4. **Michigan:** \$350,000
5. **New York:** \$1,000,000 (beginning for the 2015 tax year)
6. **Ohio Commercial Activity:** \$500,000
7. **Washington:** \$250,000

Factor Presence Nexus Standard – Multistate Tax Commission

- Substantial nexus is established if
 - A dollar amount of \$50,000 of property or
 - A dollar amount of \$50,000 of payroll or
 - A dollar amount of \$500,000 of sales or
 - 25% of total property, total payroll or total sales
- Sourcing of Revenues:
 - “The sale of services for primary use by a purchaser known to the seller in this state” – market based sourcing
 - “If the seller does not know where a service will be used, the receipts shall count toward the threshold of the state indicated by an address for the purchaser”

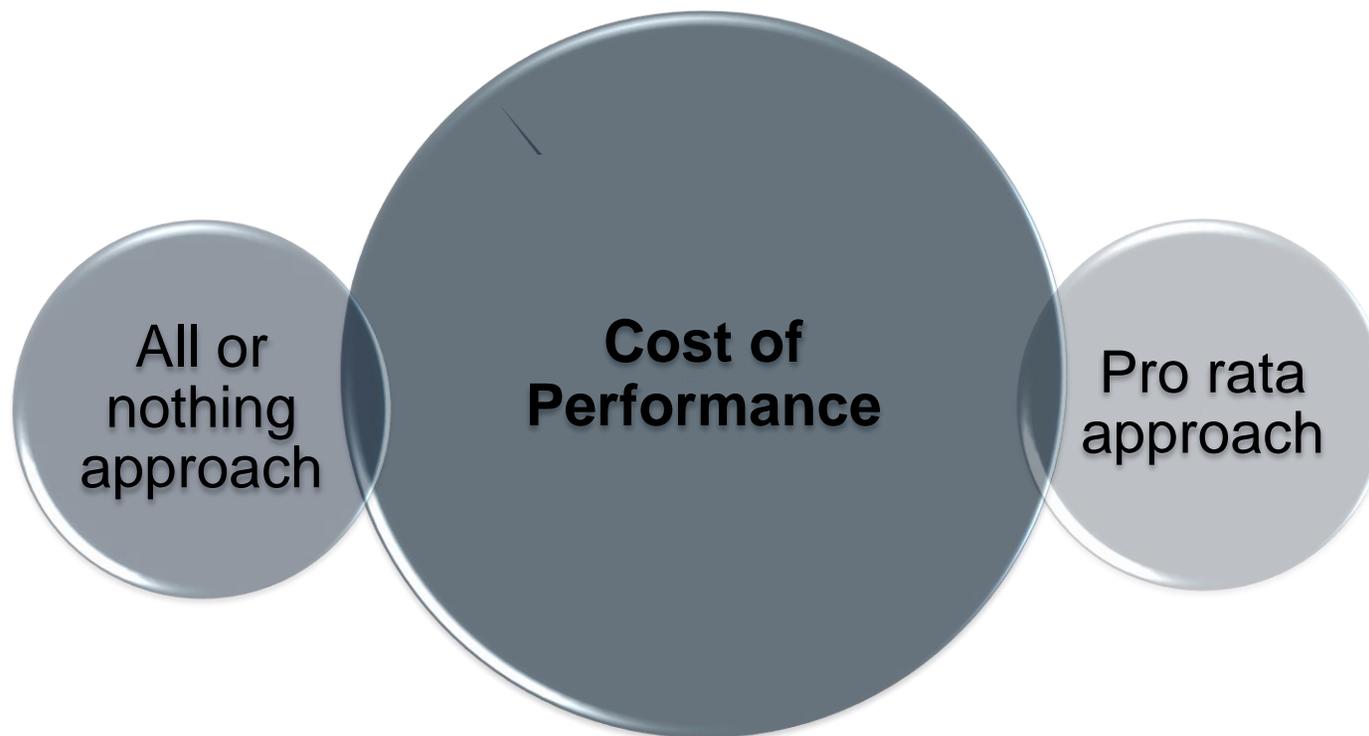
- Minnesota has been aggressive recently with Form 1099 matching
- More states are using federal information to gather information
- Several attempts to pass legislation establishing a national nexus standard have been made in Congress over the last decade, but to date, none have been successful
- Lobbying efforts and the states reluctance to give up their right to determine their own rules have helped prevent the passage of this legislation

Now you have Nexus. What revenue is sourced to the jurisdiction?

Two Methods:

1. **Cost of Performance** (Traditional approach)
2. **Market**

Cost of Performance Method: Where the work is performed



All-or-nothing vs. Pro-rata:

- All-or-nothing:
 - If the majority of the work was done in a COP, all-or-nothing state, then you apportion all of the revenue. If a de-minimis amount of work was performed, then apportion none.
 - What is the “item of service”?
 - Is this at the client level, matter level or by individual attorney hours?

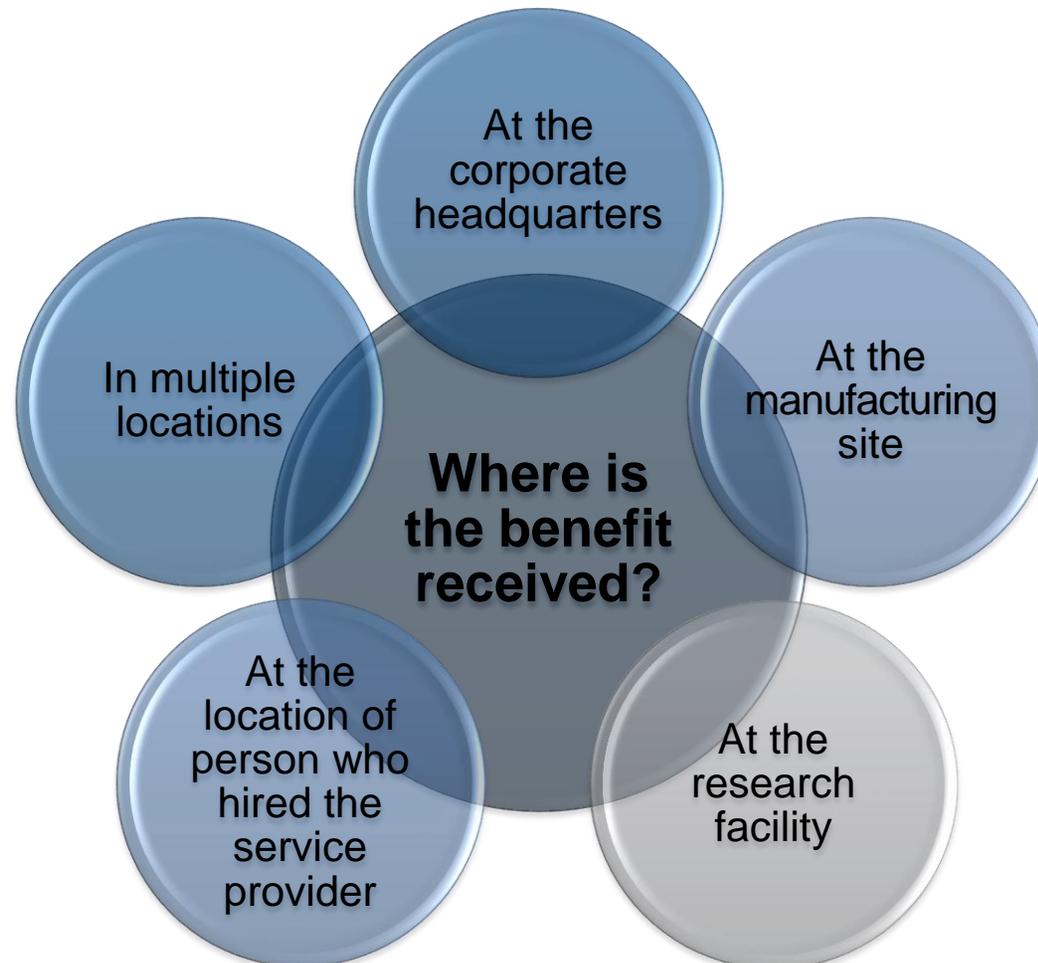
All-or-nothing vs. Pro-rata:

- Pro-rata:
 - Apportion only the applicable amount

Market Based Sourcing – Where the benefit of the service is received by the client

- More states are moving to this method
- Definitional and tracking problems with where the benefit is received
 - California definition: “Benefit of a service is received” means the location where the taxpayer’s customer has either directly or indirectly received value from delivery of that service. [Cal. Code Regs. §25136-2(b)(1)]

Market Based Approach



Many different approaches or methods for determining where the benefit is received

- How far do you need to look to determine ultimate receipt
- Order location versus billing location
- Individual customers versus business customers
- What if the determination of the where “benefit is received” is undeterminable

California Regulations are 15 pages long and contain examples

- Presumed in the state if the clients billing address in the state (method accepted by the Franchise Tax Board) [Cal. Code Regs. §25136-2(c)(1)(A)]
- Presumption may be overcome by the taxpayer showing contract or other books and records of the taxpayer that provide evidence of the extent to which the benefit of the service was received at a location or locations in the state.
- If the presumption is overcome by the taxpayer, and an alternative method cannot be determined by reference to a contract or the taxpayer's books and records, then the location where the benefit is received shall be reasonably approximated. [Cal. Code Regs. §25136-2(c)(1)(B)]

Practical Issue:

- How do companies track this
- What is considered the “item of service”
- New client/matter focus – location of client/office for whom work is to be performed
- multiple locations – if so ask for approximate breakdown of the work by location

Example – Service business:

Facts:

- Virginia is a cost of performance, all-or-nothing state
- Maryland is a market state
- The client is located in **Virginia**
- The service provider is located in **Maryland**

Maryland is a physical presence state for determining nexus. The presumption is this test has been met.

Example 1:

- A majority of the client-provided services occur in VA
 - Revenue is not sourced to MD because client is not located in MD
 - All revenue is sourced to VA because VA is a cost of performance, all-or-nothing state, and a majority of the work was performed in VA

Example – Service business:

Facts:

- Virginia is a cost of performance, all-or-nothing state
- Maryland is a market state
- The client is located in **Maryland**
- The service provider is located in **Virginia**

Maryland is a physical presence state for determining nexus. The presumption is this test has been met.

Example 2:

- A majority of the client-provided services occur in VA
 - Revenue is sourced to MD because the client is located in MD
 - Revenue is also sourced to VA because a majority of the work was performed in VA

Various statutes

MD: Gross receipts from service-related activities shall be included in the numerator if the receipts are derived from customers within this State.

NJ: If the service is performed both within and outside this State, the numerator of the receipts fraction includes receipts from services based upon the cost of performance or amount of time spent in the performance of such services.

VA: Sales, other than sales of tangible personal property, are in the Commonwealth if... the income-producing activity is performed both in and outside the Commonwealth and a greater proportion of the income-producing activity is performed in the Commonwealth than in any other state, based on costs of performance.

Need to watch partnership regulations versus corporation regulations

- PA – market based sourcing for corporations
- PA – cost of performance for partnerships/individuals
- Often the regulations between corporations and partnerships will match however in some cases it will not

Apportionment is how the amount of income to be reported to a jurisdiction is calculated

- Equal weighting of the three factors is the traditional method
- Declining tax revenues and the growing popularity of e-commerce have prompted states to adopt a heavier weighting of the sales factor or moving to single sales factor. This could potentially increase tax liabilities on out-of-state businesses (i.e., out-of-state payroll and property factors cannot reduce their overall apportionment percentages).
- States may define factors differently
 - Generally business income is apportioned
 - Generally non-business income is specifically allocated to the state in which it is earned

Actual Books and Records

- Most states require special permission to use this method
- New York State allows this without advance permission however New York City requires a traditional apportionment with a single sales factor being phased in

Three factors noted below:

- Property
 - Fixed Assets (Tangible PP) – Ending, Average, NBV
 - Rental Tangible Property – Times 8 rule
 - Rented Real Property – Times 8 rule
- Payroll
 - Payroll Accounts off of TB (Salaries, Overtime, Temp Wages, Bonuses, etc.)
- Sales
 - Fee income, Retainer income, Misc. income, etc.
 - States are moving towards single-sales factor

States require firms to withhold tax on non-resident partners

- The withholding is required to be done at the partnership level (still individual partner tax)
- Typically quarterly payments are required while some (Virginia) allow a annual payment
- The withholding rate may not always fully cover the potential individual tax liability
 - California requires withholding on distributions at a 7% rate
- Some states allow a request for exemption or waiver from withholding

Nonresident Withholding/Exemption Forms



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- Participation in a composite return generally eliminates the withholding requirement, but may create a composite estimated tax payment requirement.
- Some states have removed the composite return (Illinois) and implemented a mandatory withholding (effectively a composite return)
- Various treatment of payments made on behalf of partners

- Does the state require advance approval
- Most require that the partner have no other income from state to participate
- Some allow spouses to each participate if they each have only one source of income (i.e. both are partners in law firms and both income amounts included in composite returns)
- Virginia requires that all eligible must participate

Advantages:

- Relieves partner of individual filing obligation
- If entity pays the tax, no partner cash outlay as firm pays and then passes through to the partner
- Overall cost savings of preparing returns

Disadvantages:

- Usually pay tax at highest individual rate
- Usually lose personal exemptions, so pay tax on more income

- Partners get a credit on their home state return for taxes paid to a non-resident state
- Credit is limited to the amount of tax at home state rates
- A few states are reverse credit states so credit is taken on non-resident state return (Example is CA and VA)
- Partners should evaluate their decision to participate in composite returns in certain states due to rates

- Most states consider the employment of a person working from their home to create nexus
- Withholding and payroll taxes due to the state notifies them of the firm's presence
- Depending on method of sourcing of revenues may have little or even no income to apportion to the state
- A few states have a minimum amount that can be earned by individuals before tax is due

Many states, counties and cities have a tax that is assessed against pass-through entities

States:

- Ohio CAT
- Texas Franchise Tax – *reduced rate by 25% to 0.75% of taxable margin (effective to tax reports originally due on or after January 1, 2016)*
- Washington B&O
- Nevada – *new*

Counties:

- Virginia counties have BPOL (Business Professional and Occupational License tax)

Many states, counties and cities now have a tax that is assessed against pass-through entities – *continued*

Cities and other Taxes:

- Philadelphia – BIRT and NPT
- Wilmington DE – Earned Income Tax (City Wage Tax)
- Ohio cities
- DC Ballpark Fee
- NY MCTMT
- San Francisco gross receipts tax and payroll tax
- New York City Commercial Rent Tax

Unclaimed Property:

- Amnesty programs available

Corporate Tax:

- Minimum franchise tax

LLC Entities:

- Some states have separate LLC fees (Example CA)

Personal Property Tax:

- Clean up assets to reduce personal property tax

- DC has been very active in use tax audits
- Legal services currently subject to sales tax in Hawaii, New Mexico and South Dakota
- California undertook a study to project the revenue from collecting sales tax on services including professional services
- California, Pennsylvania and other states have had legislation introduced to begin collecting sales tax on professional services
- Illinois is looking at the possibility

Major State Changes for 2015 and Forward



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New York:

- Former cost-of-performance state, is now adopted market-based sourcing – effective January 1, 2015
- Bright-line test of \$1 million in gross receipts from New York sources will be used to determine economic nexus in New York.

New York MCTMT:

- Partnerships will report annual MCTMT information for qualified nonresident partners participating in the New York group tax return on New York Form IT-203-GR, *Group Return for Nonresident Partners*.
- Resident partners will be required to report annual MCTMT information on their New York Form IT-201, *Resident Income Tax Return*.
- Due date for the MCTMT has moved up to April 15th from April 30th.
- Essentially, a partner can either participate in the NY group return AND NY MCTMT return, or neither and file their own individual NY return.

San Francisco – Payroll Tax Expense:

- Payroll expense rate increased for 2015, retroactive to Jan. 1.
- Rate rose to 1.162% from 1.125%
- Employers are to calculate their total tax liability for 2015 at the 1.162% rate and cover the outstanding balance with their 4th quarter payment.

Missouri:

- If electing the new single sales factor apportionment – now market-based sourcing
- Advantage – can evaluate and determine which is most advantageous to the taxpayer annually
 - New single sales factor using market based sourcing
 - Standard 3 factor using cost of performance

Major State Changes for 2015 and Forward



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Nevada:

- On June 10, 2015 Senate Bill 483 was signed enacting a new commerce tax that is based on gross revenue effective July 1, 2015
- Must be engaged in business in Nevada and have Nevada gross receipts that exceeds \$4 million based on a market based sourcing
- Due August 15, 2016 for fiscal year July 1, 2015 –June 30, 2016

Tennessee:

- Revenue Modernization Act (H.B 0644) was signed into law on May 20, 2014 which enacted changes to the Tennessee Franchise and Excise Tax
- Beginning January 1, 2016, Bright-line test of \$500,000 in gross receipts in Tennessee will be used to determine economic nexus in Tennessee
- “engaged in this state” definition now includes the sale of a service delivered to a Tennessee location
- Implemented market based sourcing for services from the previous cost of performance method

Alabama:

- Effective for years after 12/31/14 for purposes of income tax and the business privilege tax established a factor presence nexus standard
- Bright-line test to determine nexus:
 - \$500,000 of sales
 - \$50,000 of property
 - \$50,000 of payroll or
 - 25% of total property, total payroll or total sales
- Sourcing of revenues – “for primary use by a purchaser known to the seller to be in Alabama”
 - The seller must apportion the receipts according to usage in each state
 - If unknown, the receipts will count toward the threshold of the state indicated by an address for the purchaser

Major State Changes for 2015 and Forward



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North Carolina:

- Phasing in 100% sales factor
- Effective for beginning on or after January 1, 2016, sales factor is triple-weighted
- Effective for beginning on or after January 1, 2017, sales factor is quadruple-weighted
- Effective for beginning on or after January 1, 2018, only the sales factor is used for apportionment
- Revenue Laws Study Committee is studying the sales factor and market based sourcing

Kansas:

- Issued notice 15-15 that gave instructions on claiming a credit for income taxes paid to another state which includes tax paid to a local jurisdiction within the state

Major State Changes for 2015 and Forward



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- Federal Filing Due Date Changes:
 - Partnership returns – from April 15th to March 15th
 - C Corporations – from March 15th to April 15th
 - S Corporations – no changes
- Effective for the 2016 filing season (return due in 2017)
- Extensions for both Partnership returns and C Corporations will remain September 15th

Questions?

The information provided here is of a general nature and is not intended to address the specific circumstances of any individual or entity. In specific circumstances, the services of a professional should be sought.

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