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Tax implications of doing business in multiple states

By Brent Watson, CPA

Doing business in multiple states has always presented challenges – and recent developments have increased challenges on the state and local tax front. Both the recent increase of employees working remotely and the U. S. Supreme Court's 2018 Wayfair v. South Dakota ruling have increased the complexities of identifying states for which payroll taxes, corporate income taxes and sales taxes must be filed. Such complexities cry out for simplification. Bills such as the Business Activity Tax Simplification Act have been introduced into Congress every year for the past 10 years, only to fail to be enacted. Simplifications in these bills have included de minimis rules for payroll taxes applicable to employees working in multiple states, clarification of nexus for income tax (modernizing Public Law 86-272) and streamlining aspects of sales tax.

More than ever, growing companies are turning to CPAs, either internally or advisors in public practice, for guidance in this regard. While it is not feasible for most CPAs to know the details of this complex area, having a basic familiarity with these issues can help you be greatly beneficial as you advise businesses expanding into new states.

Payroll taxes

All but nine states impose personal income tax on wages. States generally require employers to withhold income tax for both resident and non-resident employees who earn wages for performing services within their state, even if a company has no established location in a state. For example, sales personnel operating out of their homes are subject to payroll taxes for the state in which they reside.

With the recent explosive growth of telecommuting, the issue has arisen as to whether an employer must collect tax for additional states based on where the employee is working remotely (normally their state of residence), rather than the state in which they were normally considered to work. For example, if an employee were to be based at an Arkansas location, but is telecommuting from their home in Oklahoma, the employer could be required to withhold Arkansas taxes. Arkansas and four other states have this type of rule known as the "convenience rule." Other states take the opposite position – teleworkers are to be taxed in the state in which they worked remotely (from their home). Because of such inconsistent overlapping treatment, it could be possible that both the state in which the employee was normally based and the state from which they telecommute could assert that the employer must withhold their states' taxes.

The performance of services by a non-resident temporarily working in a state can create a tax reporting liability in that state. For employees who work in multiple states, for example, doing construction work or performing extended consulting services, the employer may be liable for withholding taxes for multiple states for a single employee in a single year. Treatment varies widely between states. A few have de minimis exemptions for non-residents working in the state based on the amount of the wages earned, days worked, etc. Further complicating this issue, some states have reciprocity agreements with adjoining states regarding the withholding of non-resident state income taxes. A reciprocity agreement allows residents of a state to request exemption from withholding for wages earned in a non-resident state. For example, Missouri and Kansas both allow residents who work across the state line to opt out of withholding tax for wages earned in their non-resident state.

Legislation has been introduced to address this maze of confusion, including the Remote and Mobile Worker Relief Act which was originally part of the U.S. Senate's COVID-19

relief bill introduced in June 2020. That legislation, like numerous similar bills which have been considered by Congress over the previous decade, would impose a 30-day national threshold for traveling employees liable for non-resident income taxes. Despite congressional efforts to provide uniformity in this area, these federal bills have gained minimal traction.

Unemployment taxes and workers compensation insurance requirements are not usually affected when an employee temporarily works in a non-resident state. Instead, they are normally determined by the location in which the employee is based for performing services, unless the employee has no fixed base of operations, in which case the tax is usually determined by the employee's place of residence.

An additional concern is that once a company registers for payroll taxes, states often presume (not always correctly) that the company is likely to have income tax and sales tax nexus. Companies that register for payroll taxes in a state should consider whether they need to register for these other taxes, as states use a matching process for these taxes to initiate nexus audits or inquiries.

Corporate income taxes

Income taxes may also apply to a company's operations depending on whether the types and level of activities in a state rises to a level of creating nexus. In order to protect remote sellers from the onerous burden of potentially having income tax compliance exposure in every state into which they make sales, Congress enacted PL 86-272 in 1959 to provide multi-state businesses with a limited safe harbor from the imposition of state income taxes.

Under PL 86-272, taxpayers whose only activity in a state is the mere solicitation of sales of tangible personal property may engage in certain protected activities without triggering a state income tax filing requirement. Unfortunately, PL 86-272 has many limitations:

- Only applies to taxes dependent on net income—and does not apply to the Texas Margin Tax, Ohio CAT, etc.
- Sales of services, including services associated with the sale of property, is not protected.
- Orders taken in a state, such as at a trade show, void this protection.

With the advent of sales tax being imposed on multi-state remote sellers based on the Wayfair case as explained below, states are increasing their efforts to impose taxes on remote sellers. Unfortunately, recent court cases (such as Tax Commissioner v. MBNA America Bank in 2006) have found that companies had nexus in a state purely on an economic basis, thereby greatly confusing the nexus issue.

Companies can be tempted to ignore the burden of apportionment of income for multistate income tax compliance. For example, for Oklahoma-based taxpayers, sales made to outside of state destinations in states in which returns are not filed are usually thrown back to and taxed in the state of origin anyway, so what is the difference? The significant problem is the loss of statute of limitations protection. If a taxpayer is found to have nexus but was not reporting tax in the state, most states can assess tax on an unlimited look-back basis. An assessment that could reach back five to seven years, with added penalty and interest, can produce shocking results. Meanwhile, amended returns to reduce the apportionment and tax in the state to which the sales were thrown back will be limited by their statute of limitations, resulting in what can be a substantial net loss.

Sales and use taxes

The U.S. Supreme Court's 2018 Wayfair v. South Dakota ruling unleased a tsunami that radically overturned foundational tenets of sales tax law pertaining to nexus, a concept meaning a taxpayer has sufficient connection with a state to allow the state to impose its sales tax laws on that taxpayer. In doing so, the Court reversed its own rulings issued over the past 51 years (National Bellas Hess, Inc. v. Department of Revenue of Ill.; 1967, and Quill v. North Dakota; 1992), which had stipulated that in order to comply with the commerce clause of the U.S. Constitution, a physical presence test must be met for states to impose their sales tax laws on a seller. This ruling established that nexus could also be based on "economic nexus" if annual sales exceeding $100,000 in value or 200 in number occur in a state.

Based on the Wayfair decision, all states except Florida and Missouri (both will almost certainly join the others this year) are requiring sales tax compliance based on economic nexus. Unfortunately, the Court did not stipulate a uniform application of this law for all states – instead leaving it to Congress to enact such law, and Congress has failed to do so. As a result, the way states apply economic nexus is not uniform in respects such as how the one year period is measured, the level of sales that is included in their threshold, what sales must be included in the measurement of the threshold (all sales, excluding resales, excluding services, etc.), how long taxpayers have to register after hitting the threshold, etc.

The enactment of economic nexus did not replace the requirement of physical presence to establish nexus – it added another trigger. Nexus continues to be established based on physical presence in a state regardless of value of sales into the state. Factors that generally constitute physical nexus in a state include delivery by the seller's vehicles, making regular sales calls, or having employees or agents making repairs or installations.

Sellers with nexus creating activity in a state should register for a sales tax account and begin to collect tax and exemption certificates in the state. Sellers having a high number of sales that are spread over multiple state and local jurisdictions, or who have numerous customers for whom they must track exemption certificates, should consider usage of sales tax software.

Self-Study CPE Details

Interest Area: State and local tax

Designed for: CPAs in public practice interested in taxation

Objective: Provide an overview of state and local tax matters affecting multi-state businesses.

Level: Intermediate

Prerequisite: None

MUST BE COMPLETED AND SUBMITTED BY JUNE 30, 2021 TO QUALIFY.

Such software, if properly integrated with billing, can save time and potentially reduce audit exposure by accurately applying correct state and local taxes and making it easier to report them. The cost of this software has become more affordable. Some sales tax software includes matrices that assist with determination of taxability for a range of products in various states.

Businesses expanding sales to a multi-state platform should be aware that states vary as to how tax applies to transactions. For example, repair services may be exempt in the company's home state but taxable in a neighboring state. Sales tax treatment for various industries varies vastly between states. For example, in Oklahoma, contractors are consumers and pay tax on all materials used in construction, while their services are not taxable; whereas the neighboring states of Kansas, New Mexico and Texas tax repair of real property and, in some cases, materials if separately stated. The manufacturing exemption in Oklahoma is very generous, covering materials consumed in manufacturing, repair parts etc., whereas those items are taxable to varying degrees in neighboring states. And while Oklahoma provides few exemptions to oil and gas producers, certain equipment is exempt in Kansas and Texas.

Registration to do business

Being registered to do business is referred to as being "qualified" [to do business]. Being qualified in a state provides that business with legal standing in the state; without qualification, businesses have no ability to proceed in the state's courts. In some cases, penalties can be imposed on businesses who are "doing business" in a state, but who do not become qualified in the state. Activities that generally constitute doing business in a state include: 1) having physical locations where business is conducted (simply owning real property isn't considered doing business); 2) having employees (using independent contractors is not generally considered doing business); 3) entering into binding contracts in the state; 4) having regular meetings with customers; and 5) having a significant revenue stream.

Being registered to do business will generally require designation of a corporate representative and filing of a simple annual report that often incurs a nominal fee. It does not automatically require filing of corporate income tax returns.

Property taxes

Having property in additional states not only is a nexus-causing factor for sales and income taxes, but also may result in requirement to file business personal property renditions. All but about 10 states tax business personal property generally. In contrast, only 10 mostly southeastern states apply tax to inventory (AK, AR, KY, LA, MS, TN [raw materials but not finished goods], TX, VA, VT and WY). Some of those states allow for filing for a "Freeport Exemption," which can reduce property tax costs. In states where inventory is not taxable, equipment and fixtures at a business location likely will be taxable. Unfortunately, most states do not provide de minimis exemptions.

Summary

Whether as an advisor or an employee, CPAs who are responsible for the impact of taxes on companies expanding operations to additional states should familiarize themselves with state and local tax implications that come with such growth. Failure to avoid these tax traps or cure them early can result in exposure that can damage or even ruin a business. Those costs often appear as the outcomes of audits, requirement to disclose such liabilities in financial statements or inability to sell a business because of liabilities discovered during the due diligence process.

CPE Self-Study Section: Earn CPE credit for reading the article on pages 18-20

Earn one hour of CPE credit by reading the preceding CPE article and completing the provided self-study exam on page 21. Mail in the completed exam by June 30, 2021, to the OSCPA Education Department for grading. If you receive a score of 70% or higher, you will be issued a certificate for one hour of CPE credit, dated as of when the test arrives in the OSCPA office. If you score below a 70%, you will be notified of your score and may be allowed to retake the exam. The answers for this exam will be printed in the next issue of the CPA*FOCUS*.