Perils of Doing Business in Multiple States

As if the economic downturn wasn't bad enough, state taxing authorities are on the warpath — and your business may very well be in their crosshairs. In response to budget woes and empty coffers, state taxing authorities are actively targeting both in-state and out-of-state companies for income and sales tax compliance.

Revenue agencies are aggressively employing random audits and blanketing entire industries with business activity and nexus questionnaires. Thanks to improved data sharing capabilities, revenue agencies are cooperating across multi-state areas, leaving no leaf unturned.

Highway Robbery?

In an almost unbelievable case, New Jersey State Police, aided by state revenue agents, stopped trucks with out-of-state markings on the New Jersey Turnpike. Drivers were queried about the business activity of the company for whom they were delivering and, if it was deemed that the company was indeed conducting business in the state, the trucks were seized and held until a "jeopardy tax" was paid.

Tightening the Nexus Noose

But it's not just aggressive tax authorities. Now, new legislative initiatives are replacing normal income tax with new tax schemes that are not solely based on income. Some of the most recent legislative changes include:

Ohio — Ohio's Commercial Activity Tax (CAT) replaced the state's corporation franchise tax and tangible personal property tax with what is basically a "business privilege tax" based on gross receipts. In its efforts to shift some of the tax burden to out-of-state businesses that sell into Ohio, the Ohio state legislators established an aggressive nexus standard known as the "brightline" nexus standard.

Under this standard, an entity "has a substantial nexus with" Ohio if it has at least:

- $50,000 worth of property in the state at any time during a calendar year;
- $50,000 of payroll in the state during a calendar year; or
- $500,000 of Ohio taxable gross receipts during a calendar year.

Alternatively, if a business employs 25 percent of its total property, payroll or gross receipts in Ohio during a calendar year, it will have nexus with the state and be subject to the CAT.

Washington — With no corporate or individual income tax, the State of Washington relies heavily on its business and occupation (B & O) tax, an apportioned gross receipts tax on most business activity in the state. Unwary out-of-state companies can easily run afoul of nexus standards by engaging in these seemingly innocent activities:

- Installing or assembling goods in the state, either by employees or other representatives
- Maintaining a stock of goods in the state
- Renting or leasing tangible personal property
- Providing services
- Making repairs or providing maintenance or service to property sold

Michigan — Michigan's two-prong business tax (both a business income and modified gross receipts tax) utilizes an extremely aggressive nexus standard. Companies are subject to the tax if they have a physical presence in the state for more than one day during the tax year or "actively solicit" sales in Michigan. The state has very broadly defined “solicitation” to include use of the Internet, mail or telephone; use of print, radio, television or other advertising; or by maintaining an Internet site over or through which sales transactions occur with residents. Once nexus is established, a tax can be levied — typically based on the proportion of a company's sales, property and personnel in the state.

A Mistaken Sense of Safety

Many companies have mistakenly clung to protections afforded by Public Law 86-272, a 1959 Federal statute that prohibits states from taxing the net income of an out-of-state business whose only business activities within the state consist of merely “soliciting” orders for the sale of tangible personal property which orders are sent outside the state for approval and are filled by shipment or delivery from a location outside the state.

Unfortunately, the definition of “soliciting” can vary by state and can get extremely complicated. Here’s an example:

Assume you have a Texas-based business that sells fruit-sorting equipment. Your Texas-based salesman travels to Georgia to solicit the order from a large peach grower. Your sales rep makes the presentation in Georgia, but the acceptance of the orders (i.e., as to credit, terms and financing) all go through the home office back in Texas. So far, so good; you are clearly not considered to be doing business in Georgia. But, a week later the same employee returns to Georgia to inspect the equipment after it was shipped and installed. Believe it or not, the act of inspecting the equipment crosses the line of solicitation and you are considered to be doing business in Georgia!

In addition, PL 86-272 does not apply to sales of services, real property nor intangible property. And importantly, it does it offer protection from the gross receipts tax used by states such as Ohio, Texas, Washington and Michigan in lieu of a corporate income tax as discussed above.

Coming to a Mailbox Near You …

State taxing authorities are increasingly aggressive in identifying potential taxpayers. Their tactics range from surprise visits to the more common business activity or nexus questionnaire. Here, taxing authorities may cast a wide net, querying every registered business in a given industry.

A routine business activity questionnaire can easily wind up in your company mail and get ignored (or, worse, the wrong person within the company responds and provides inappropriate answers). Other times, companies feel they must respond either “yes” or “no” to the questions, when they would be better served by attaching a detailed written response. Bottom line: Responses to what may appear to be a routine questionnaire should not be taken lightly.

Are You a Target?

Small and midsize businesses are typical targets, as revenue authorities know that smaller businesses often don't have a tax department (and can’t or don’t want to pay a professional to review all of the different states in which they may do business).

Even the wording on an employment agreement or contract could trigger taxes. The person your company considers to be in a support or marketing role could be deemed a “salesperson” in the eyes of the state, thus triggering nexus issues.

And while Public Law 86-272 protects certain in-state activities conducted by independent contractors, the protections are not absolute. For example, a number of states have ruled that the mail-order computer industry’s practice of providing in-state warranty repair services through third parties creates nexus, thus making the mail-order vendors liable for sales and use tax.

Because You Need Answers

Business owners are well advised to seek competent tax and accounting counsel before responding to a state's request for nexus or business activity information — even if they feel they have no tax liability in that state.

An experienced tax or accounting professional can provide invaluable guidance and help in formulating an appropriate response to state revenue authorities. This typically includes a thorough risk analysis with a pro-forma calculation of potential tax exposure. In addition, he or she can advise you on planning techniques that can help avoid or mitigate sales tax issues.

Through our membership in PKF North America, we are in touch with member firms across the country to stay abreast of emerging issues in other states so we can advise our clients.

If you would like additional information or if you would like to discuss this in more detail, please us at (937) 223-7272.