MOSSADAMS

MANAGE YOUR COMPANY'S STATE AND LOCAL TAX PROFILE

Updated April 2021

NAVIGATING POSSIBILITIES

CONFRONT THE NOT-SO-HIDDEN COSTS OF FAILING TO PLAN AND MANAGE STATE & LOCAL TAX ISSUES

If left unattended, state and local tax issues can wreak havoc on your company's hard-earned success and place a heavy burden on your team's valuable time. It's critical to stay ahead of potential challenges and have a plan to manage your company's state and local tax issues from an early stage in the company's life cycle.

A lack of control over your company's state and local tax issues could arise at the most inopportune times, such as preparing for an exit event or an inquiry from a state tax auditor. Without strong policies and procedures in place, your team could waste significant time addressing questions or issues instead of running the business.

Once identified, unpaid state and local taxes could also result in large changes to the company's earnings before interest, tax, depreciation, and amortization (EBITDA) or net income. This could erode shareholder value through unplanned tax payments, reductions to purchase price, and the creation of escrows.

At that point, unfortunately, the solution requires more than adding money to an escrow or paying tax liabilities. A business might be required to add headcount or take employees off critical business matters to address the state and local tax concerns. In addition, many buyers now require the seller to pay for advisor fees to correct state and local tax underpayments.

While there are many reasons state and local tax issues can be complicated, there are concrete, proactive steps you can take to help bypass unpleasant surprises down the road. Before addressing potential solutions, however, it's important to understand the complexity of the state and local tax systems that cause problems.

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Complications of State & Local Tax Landscape

Every state and local taxing jurisdiction approaches taxation differently—this is the primary reason state and local tax issues are so complicated.

States generally collect revenue from businesses through some or all the following taxes.

Income and franchise taxes	These taxes are imposed on the apportioned and/or allocated profit or net worth of a company.
Sales, use, or other revenue-based taxes	These taxes are imposed on the value or gross receipts of specific transactions. Some are passed on to the customer while some are absorbed by the company.
Property taxes	These taxes are imposed on the assessed value of tangible and/or real property.

To illustrate the complexity of state tax systems, consider the following:

- Nevada, Ohio, Texas, and Washington State don't impose corporate income taxes; instead they impose taxes on the gross receipts of the business.
- Alaska, Delaware, Montana, New Hampshire, and Oregon don't impose sales taxes. However, Oregon imposes a modified gross receipts tax in addition to its net income-based tax, and certain localities in Alaska impose sales taxes.

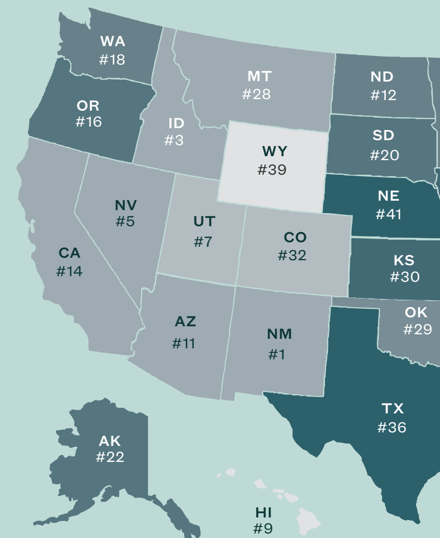
With all these complexities, it can be difficult to determine where to start. The beginning of any solution is to diagnose where the problem exists. For state and local tax matters, the problem exists for a business only in the jurisdictions where it has a taxable presence, commonly referred to as nexus.

State and local authorities can't impose a tax on a business unless nexus exists with the particular jurisdiction. A business can have nexus based on either its physical presence or its economic activities. These conditions are discussed in the next section.

HOW HIGH ARE TAX RATES IN YOUR STATE?

PROPERTY TAXES

An illustrative example of the mean effective property tax rates from 2021 on ownership-occupied housing*



Note: A rank of 1 is best, 50 is worst. D.C.'s score and rank don
The report shows tax systems as of July 1, 2020 (the beginnin

Source: Tax Foundation; 2021 *State Business Tax Climate Ind*

Note: City, county, and municipal ra
average local tax rate. The sales ta
include many business-to-business
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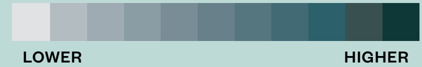
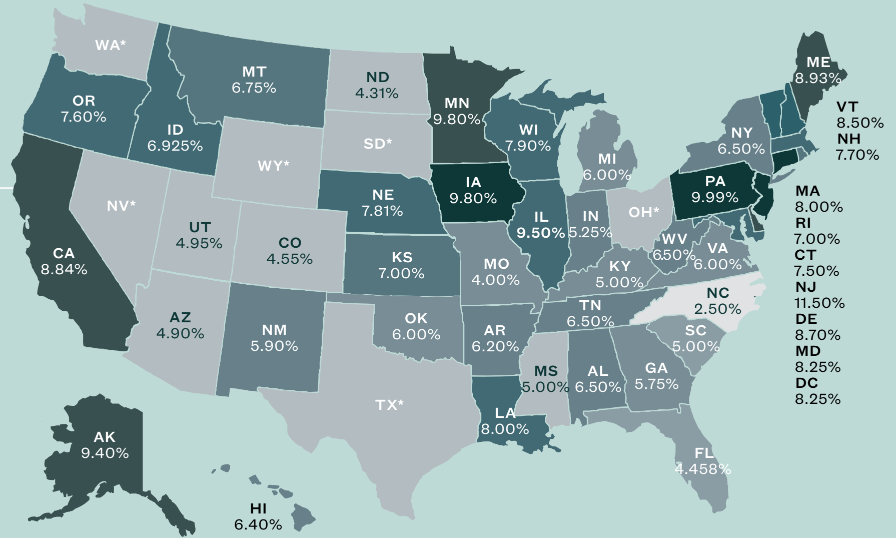
Source: Sales Tax Clearinghouse; T

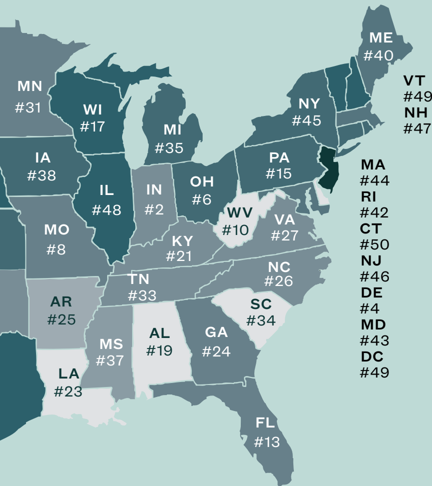
*State doesn't impose a corporate i

CORPORATE INCOME TAX

Top state marginal income tax rates as of January 1, 2021







Note: (*) Nevada, Ohio, Texas, and Washington State don't have a corporate income tax but do have a gross receipts tax with rates not strictly comparable to corporate income tax rates. Delaware, Tennessee, and Oregon have gross receipts taxes in addition to corporate income taxes, as do several states like Pennsylvania, Virginia, and West Virginia, which permit gross receipts taxes at the local, but not state, level.

Illinois' rate includes two separate corporate income taxes, one at a 7% and one at a 2.5% rate. Indiana's rate will change to 4.9% on July 1, 2021. In New Jersey, the rates indicated apply to a corporation's entire net income rather than just income over the threshold. A temporary and retroactive surcharge is in effect from 2020 to 2023, bringing the rate to 11.5% for businesses with income over $1 million. In addition to regular income taxes, many states impose other taxes on corporations such as gross receipts taxes and capital stock taxes. Some states also impose an alternative minimum tax and special rates on financial institutions.

Source: Tax Foundation; state tax statues, forms, and instructions; Bloomberg Tax.

't affect other states.
g of Fiscal Year 2021).

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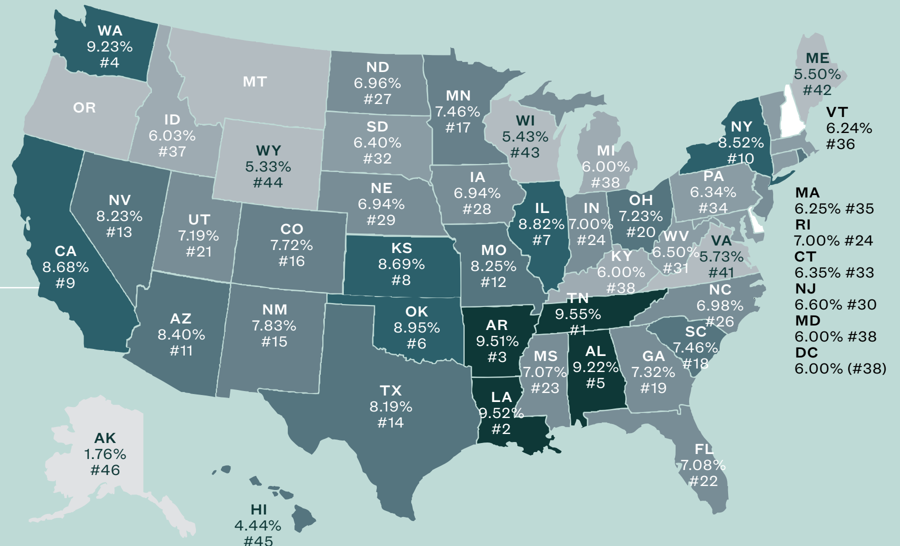
SALES TAXES

Combined state and average local sales tax rates from January 2021



tes vary. These rates are weighted by population to compute an
xes in Hawaii, New Mexico, and South Dakota have broad bases that
services. D.C.'s rank doesn't affect states' ranks, but the figure in
ld rank if included.

ax Foundation calculations; State Revenue Department websites

ncome tax, but may impose a gross receipts or margins tax.

Nexus Considerations: All States Aren't Equal

In this section:

Income Tax and Gross Receipts Tax Nexus

Sales & Use Tax Nexus

You won't have a state and local tax filing obligation unless you have nexus with a particular jurisdiction, regardless of whether the products or services are purchased directly through your stores, your website, via referral agents, or an online marketplace.

Unfortunately, a nexus determination varies not only by taxing jurisdiction, but also by the type of tax. For example, sales tax nexus requirements may differ from income tax nexus requirements. Accordingly, a business could have a requirement to collect and remit sales tax, but not have a requirement to file an income tax return.

This lack of uniformity among state and local tax jurisdictions and taxes imposed by these jurisdictions can cause a great deal of uncertainty to fully understand your company's state and local tax profile.

Further, with a reduction in federal funding, many state and local tax legislators and officials are hungry for additional sources of tax revenue. To avoid raising the tax rate, they often resort to actively broadening their state's definitions and nexus interpretations to expand the tax base.

To account for this complicated tax guidance, it's important to determine up front where your company has nexus and which activities performed by the company could cause nexus.

INCOME TAX AND GROSS RECEIPTS TAX NEXUS

Generally, nexus rules fall into three categories:

- Physical presence
- Economic presence
- Factor presence

Currently, most states use a combination of these categories to impose a filing obligation on companies that conduct business in their state.

Physical Presence

Physical nexus is considered the clearest test of established presence in a tax jurisdiction. Having employees, property, or other physical presence in a tax jurisdiction generally establishes nexus.

This is usually an easy assessment when an out-of-state business has employees located in the taxing state. Other less obvious activities may also establish nexus, such as the in-state presence of contractors, agents, and traveling sales professionals. Customer installations, training sessions, and trade show attendance may establish nexus as well.

Some states provide minimum day thresholds or safe-harbor rules for certain types of activities—trade shows or conferences, for example. Although physical presence no longer appears to be constitutionally necessary to create nexus, it's still sufficient, and many states continue to have physical presence requirements in their statutes or regulations.

Economic Presence

A growing number of states assert that an economic presence—regardless of physical presence—is sufficient for a state to impose an income-based tax on a company. This means a company is subject to a state's taxing authority if it derives revenue from within the state's borders.

The methodology used to determine whether or not an out-of-state business derives revenue from the state may vary. Some states base this determination on whether the business has in-state customers as represented by the customer's physical location or address, whether it's bill-to or order-from.

Other states require a more nuanced analysis that focuses on where the benefit of service is received. This is a much broader interpretation than physical presence and can be difficult to navigate absent a detailed review of the relevant statutes and regulations.

Factor Presence

Many states adopted factor-presence nexus standards. This means a taxpayer is subject to income tax or a gross receipts tax when the taxpayer's gross receipts, payroll, or property in a given state exceed certain thresholds. For example, the state of Colorado has a factor presence nexus threshold of $500,000 in sales during a tax year.

Special Rule for Solicitation of Sales of Tangible Personal Property (Public Law 86-272)

One critical item to consider is a special rule aimed solely at businesses that sell tangible personal property. Specifically, the US government passed legislation in the 1950s that protects taxpayers from the imposition of income-based taxes by states if the only activity of a company in a state is the solicitation of the sale of tangible personal property that's shipped from outside the state, and the order is approved from outside the state.

This federal law is in much disfavor with the states. As a result, many states interpret this law narrowly.

SALES & USE TAX NEXUS

What Is Sales & Use Tax Nexus?

Nexus is the necessary sufficient connection that an entity must have for a state to impose registration, collection of tax, and filing of tax returns on sales into the state.

Historical Backdrop of Sales & Use Tax Nexus

For many years, a 1992 landmark ruling on nexus—*Quill Corp. v. North Dakota*—dictated the rules for sales tax nexus. The US Supreme Court determined that an entity must have physical presence in a state to establish sales and use tax nexus.

The Supreme Court overturned *Quill* on June 21, 2018, in *South Dakota v. Wayfair* and found that economic presence in the form of $100,000 of annual sales or 200 or more sales transactions into the state was sufficient to require sales tax registration and collection by remote sellers.

Nexus Rules Post June 21, 2018:

The rules state:

- Physical presence isn't necessary in the state
- Exceeding a defined sales dollar volume or number of transactions in preceding periods is sufficient to create nexus

South Dakota Example

A business without physical presence in South Dakota that meets one or both of the following criteria in the previous or current calendar year is required to register:

- Gross revenue from sales into South Dakota exceeding $100,000, or
- Sales for delivery into South Dakota in 200 or more separate transactions
- Gross sales or transactions include sales of tangible goods, products transferred electronically, or services

States Adopting Economic Nexus Rules and Marketplace Facilitator Rules

States quickly followed South Dakota in enacting *Wayfair* economic nexus statutes; currently 43 states that impose a sales tax or similar transaction tax and the District of Columbia now have economic nexus rules.

The adoption of economic nexus standards also prompted many states to adopt marketplace facilitator collection requirements. In these states, a third-party marketplace—eBay and Amazon are two prominent examples—may be required to collect sales tax rather than the vendor itself as a marketplace facilitator.

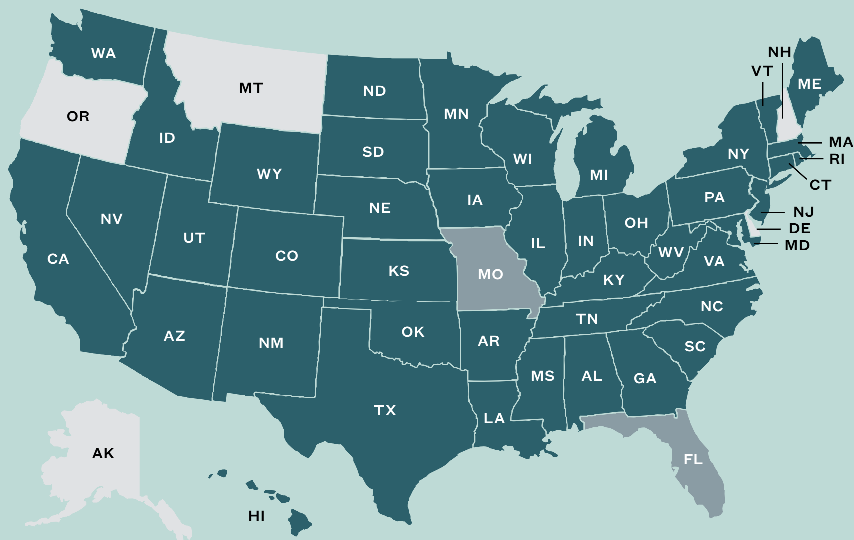
Marketplaces for software apps also qualify as marketplace facilitators—the Apple App Store or Google Play are examples of platforms that several states require registration, collection, and filing of sales tax returns.

ECONOMIC NEXUS JANUARY 2021:

States with economic nexus standards

States with proposed economic nexus legislation

States without economic nexus standards or proposed economic nexus legislation



Source: Effective January 1, 2021

Income & Other Direct Taxes

Many companies overlook some of their income tax issues in early years because they aren't yet profitable or they're unaware of the income tax implications of selling to customers located in other states.

Before deciding whether or not to file, it's important to understand how revenue is sourced in each state and how taxable income or loss is apportioned to a state to determine the company's state income and gross receipts tax exposure.

In general, a business' taxable income or loss is apportioned among the states according to each state's relative amount of sales, payroll, or property compared to a business' total sales, payroll, or property. The states vary in the weight given to sales, payroll, and property within and outside the state. For example, California uses a 100% sales factor to apportion income.

Sales-Factor Sourcing

Sales of tangible personal property and software downloads are typically sourced to the location of the ultimate destination of the sale. However, sourcing sales of services—software as a service (SaaS), platform as a service, and infrastructure as a service are examples—differs. States have historically used one of two sales sourcing methods for services:

- Cost-of-performance method
- Market-based method

COST-OF-PERFORMANCE (COP) METHOD

The older approach, this method sources service revenue to the state where the income-producing activity is performed.

If that activity is performed in more than one state, the revenue is generally sourced to the state where the greater COP of the income-producing activity occurs.

MARKET-BASED METHOD

Many states have moved to a market-based sourcing approach. This method sources sales of services to the location of a taxpayer's market. Generally, a taxpayer's market is defined as the location where a customer receives the benefit of the service, where the service is essentially delivered, or where a customer is located, depending on the state.

If the benefit of the service is received in multiple states, or if a service is delivered to multiple states, there may be an opportunity to reduce the amount of revenue attributable to certain states.

METHOD COMPARISON

While the cost-of-performance method proved to be the preferred method of sourcing in the past, more states are turning to market-based sourcing in an effort to expand and export their tax base to out-of-state taxpayers.

The number of states that moved to this approach grew substantially since 2015. This means a company's income tax liability is increasingly tied to where their product or service is used, consumed, or where a customer receives the benefit of the product or service, not merely where the company is physically located.

To add further complexity, market-based sourcing may appear to be simple, but it has many different interpretations. Even COP states are becoming more complicated. Some states, such as Indiana, are disregarding COP rules in favor of finding an income-producing activity in the customer's state. This can lead to a variety of complicated tax questions, such as who should be considered the purchaser of record and where the benefit is actually received.

This pattern is complicated by the fact that different states utilize different methods.

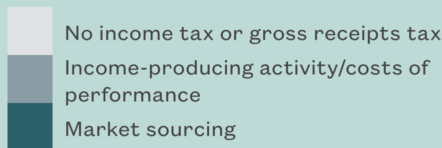
Other Direct Taxes

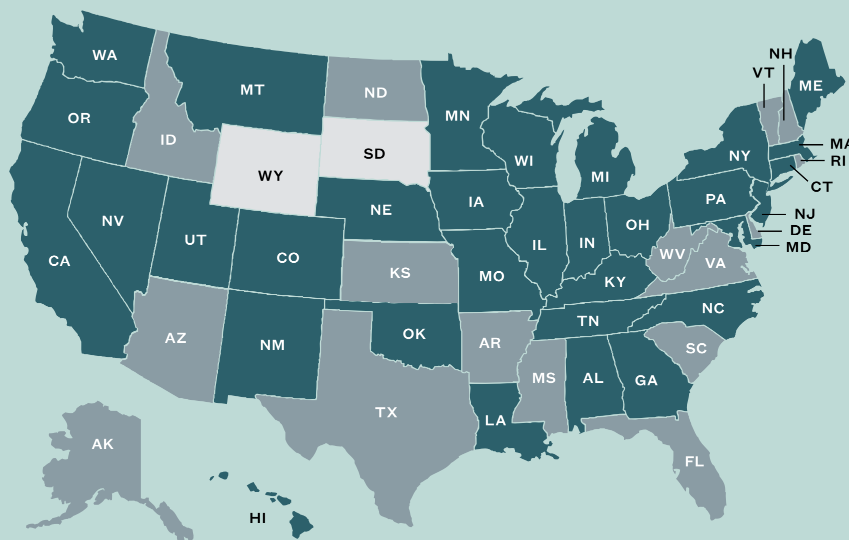
Other direct taxes may be assessed on gross receipts from in-state customers. Examples of these direct taxes include, but aren't limited to:

- Washington's Business and Occupation Tax
- Oregon's Commercial Activity Tax
- Texas' Margin Tax
- Ohio's Commercial Activity Tax

These taxes are imposed regardless of business profitability, so they must be examined when selling to customers in these states.

SALES OF SERVICES: APPORTIONMENT STATE APPROACH



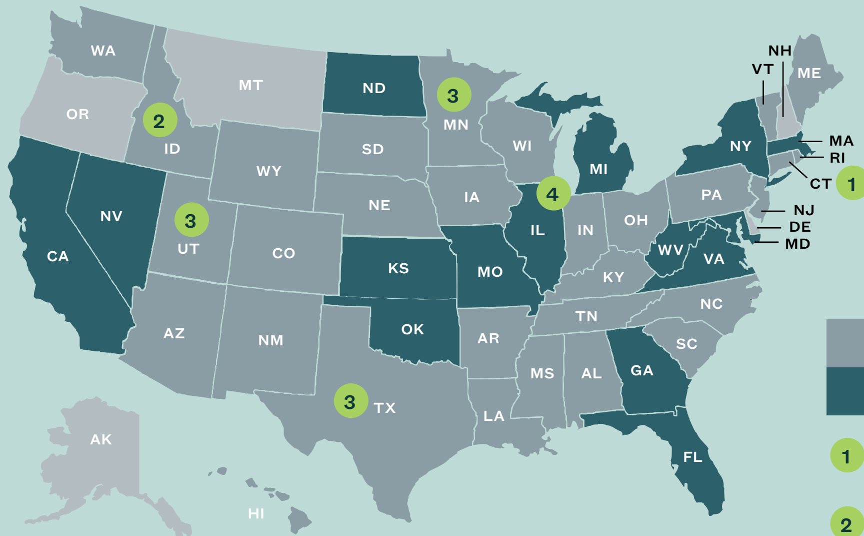


Source: Effective 1/1/2021.

Note: Kentucky, Montana, and Oregon effective 1/1/2018. Colorado effective 1/1/2019. New Jersey effective for tax periods ending on or after 7/31/2019. Hawaii, Missouri, New Mexico, and North Carolina effective 1/1/2020.

SALES TAX BY STATE FOR 2021: WHERE ARE DIGITAL PRODUCTS TAXABLE?

Charge sales tax on digital books, movies, or music?



Digital goods are taxable

Digital goods aren't taxable

1. Taxable at a reduced rate of 1%
2. Permanent sales are taxable while temporary sales (rentals) are tax exempt
3. Digital products are taxable if they're equivalent to a product that would be taxable if sold in a physical format
4. IL — The city of Chicago imposes an amusement tax on digital products

Source: : RIA/Thompson Reuters; Effective January 31, 2021

Sales & Other Indirect Taxes

Generally, states impose sales tax on the transfer of tangible personal property and certain enumerated services unless there's an exemption available to the buyer. However, software and related services is a complicated topic that many state tax agencies encountered in recent years.

Some states specifically dealt with the taxability of computer software and other technology through legislation or administrative regulation. However, more than half of states don't have any statutory or regulatory authority covering SaaS. The sales taxability of SaaS and other related technology services constantly evolves.

Downloaded Software

More than half of states have specific authority covering the taxability of downloaded software. Downloaded software is usually software that isn't delivered to a customer in a tangible medium. Examples of such delivery methods include electronic delivery or transfer by load-and-leave software delivery.

States typically tax downloaded software if the software is prewritten, as opposed to custom software. *Prewritten computer software* is software that isn't designed and developed by the author or other creator to the specifications of a specific purchaser. *Custom software* is typically created for a specific purchaser.

SaaS

About 20 states have statutory, regulatory, or administrative guidance on the taxability of SaaS. SaaS is described as web-based software that's hosted by the service provider, but some states also refer to it as remotely accessed software.

SaaS differs from downloaded software. Downloaded software is downloaded upon purchase, whereas SaaS is software that's remotely accessed on the provider's server. Many states won't impose sales tax on SaaS for two reasons: it isn't tangible personal property nor is it enumerated as a taxable service.

The imposition of sales tax on SaaS is rapidly growing, however, as state legislatures expand their sales tax base and aggressively interpret taxable transfers of software.

Data Processing and Information Services

Data processing and information services generally allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser, where the purchaser's primary purpose for the underlying transaction is processed data or information.

Examples include:

- Summarizing data
- Computing data
- Extracting data
- Sorting files
- Sequencing files

Many states don't impose sales tax on data processing and information services because they aren't among the taxable services enumerated in the law. However, there are exceptions—New York, New Jersey, and Massachusetts, for example, impose sales tax on information services.

Exceptions can apply under certain circumstances, and states often provide exceptions to the general rules that aren't readily identifiable. For example, Ohio imposes sales tax on information services, but only when sold to a business. Washington, meanwhile, imposes sales tax on digital automated services but with various exceptions for advertising services and online marketplaces.

Property Taxes

Every state imposes a real property tax. However, many companies overlook the significant number of states that also impose a property tax on tangible personal property administered at either a state or county level.

Taxpayers operating in multiple states often encounter personal property tax issues when they have equipment situated across the country. Even though a business may not own the building, in-state equipment is generally subject to personal property tax.

A handful of states also impose property taxes on inventory located in the state. The lack of uniformity among states on how to tax real property and tangible personal property can lead to a compliance headache for taxpayers. Without a comprehensive understanding of how business property is taxed within each state a business operates, taxpayers risk incurring a much higher than necessary property tax expense.

Other taxes also act as pseudo property taxes. These are usually tied to a taxpayer's rent or office space and often catch taxpayers off guard because they aren't common knowledge and aren't incorporated into a taxpayer's rent, as one might assume.

For example, the city of Bellevue in Washington imposes a square-footage tax, and New York City imposes a commercial rent tax on gross rents exceeding a certain threshold. These nuanced and little-known taxes often fly under the radar without the expertise of a state and local tax professional, leading to unanticipated tax bills and the potential for penalties and interest if left unpaid.

Credits & Incentives

To create jobs and encourage investment, many states are rolling out more credits and incentives available to qualifying taxpayers.

The opportunities often take many different forms and can apply toward different types of taxes. These taxes are outlined below.

Tax Credits Available to All

Many states—Arizona and California, for example—offer R&D tax credits similar to the federal income tax version of the credit for in-state research activities, which are incremental to the federal R&D tax credit.

Additionally, many states offer R&D tax credits targeted at specific industries. For example, Washington offers a gross receipts tax credit for research related to development of commercial aerospace products and tools, while Idaho offers an income tax credit for investment in broadband equipment used to provide internet access services.

Tax Credits Available by Application

Some states offer various income tax credits that require taxpayers to either apply for or otherwise certify the credits before claiming them on a tax return. For example, California offers the California Competes Tax Credit to businesses that commit to certain employment or project investment requirements. California's credit requires an application and negotiation.

On the other hand, Colorado offers tax credits for increased hiring and employee medical coverage to taxpayers building in enterprise zones. These credits must be applied for in advance but don't require negotiation.

New York offers a statewide program called StartUp New York which offers expanding businesses the opportunity to go completely tax free for up to 10 years, provided they relocate to specific areas.

Sales Tax Exemptions

Most states offer sales tax exemptions for machinery and equipment to encourage investment in manufacturing facilities. For example, Virginia provides a sales and use tax exemption for large investments in qualified data center equipment.

States recognize this and are starting to expand these types of incentives to software manufacturers and other technology companies. Washington started in 2016, for example.

Federal Hiring Tax Credits

The Work Opportunity Tax Credit is a wage-based income tax credit available to businesses that hire individuals that may face barriers to employment and qualify under defined target groups. Target groups include, but aren't limited to:

- Food stamp recipients
- Felons
- Unemployed individuals
- Veterans who may be unemployed, disabled, or recently discharged from active duty

Depending on which target group a new hire qualifies under, the maximum credit per new hire can range from $2,400 to $9,600.

Credits & Incentives Continued

Federal Wage-Based Tax Credits

Periodically as natural disasters occur, the federal government will pass legislation for Disaster Relief Tax Credits. These credits allow businesses that become inoperable as a result of a federally declared disaster to calculate a credit based on the wages paid to employees retained during such period when they were unable to perform their job responsibilities. The maximum credit amount available per qualified employees may be worth up to $2,400.

In addition to Disaster Relief Tax Credits, employers that provide a paid family and medical leave benefit—in excess of state-mandated leave programs—may be eligible to calculate a credit based on the wages paid to employees who took a qualified leave during the 2018 and 2019 tax years.

The maximum credit available ranges widely based on the length of leave taken and the percentage of paid leave wages paid to such employees.

Transferable Tax Credits

Many states offer tax credits for investment in film production, historic rehabilitation projects, low income housing projects, renewable energy projects, and other initiatives to spur economic growth, expand job opportunities, and enhance innovation.

Some states also allow the transfer of these credits to another taxpayer. This means taxpayers could reduce their state tax burden by purchasing other businesses' credits or increase cash flow by selling earned credits.

Depending on the state, the type of credit, and the types of taxes that may be offset, the prices can range from $0.70 to $0.95 per dollar of credit purchased. For buyers, beyond the potential to deliver a high rate of return, transferable tax credits can also help taxpayers in the following manners:

- Reduce your total state income tax liability
- Lower your effective state tax rate
- Diversify your investment portfolio
- Promote the arts and film, renewable energy, historic rehabilitation, affordable housing, or other industries you may support

Mitigation Strategies

After taxpayers determine they have tax exposure in a state, the next step is to find the best way to mitigate exposure. The two most common mitigation methods are through voluntary disclosure agreements and amnesty programs.

Voluntary Disclosure Agreements

Every state offers some variation of a voluntary disclosure program that's open to all qualifying taxpayers. With this program, a taxpayer comes forward voluntarily to report its unpaid or underpaid state and local tax obligation. Voluntary disclosure provides two distinct benefits:

- A lookback-period reduction of three to four years in most circumstances, which reduces tax, interest, and penalties for forgiven tax years
- Abatement of penalties for the disclosure period

There's also an indirect benefit for the taxpayer: the opportunity to drive the presentation of its liabilities as opposed to initially going through a time-consuming audit.

Generally speaking, to participate in voluntary disclosure programs, a taxpayer must not have filed returns for the periods it wishes to come forward on and must not have been contacted by the state for enforcement purposes.

Many states have varying criteria that may limit the benefits under a voluntary disclosure agreement.

Amnesty Programs

Many states periodically offer amnesty programs for a limited period. Often, the terms for amnesty programs—limited lookback period or abatement of penalties or interest, for example—are similar to voluntary disclosure programs.

However, amnesty programs occasionally differ in that taxpayers that already filed returns with the state may be able to disclose additional liabilities not previously reported. Amnesty program requirements and limitations vary significantly in each state.

We're Here to Help

If you'd like more information on state and local tax matters and how they might affect your company in each state, contact your local Moss Adams professional or email **statetax@mossadams.com.**

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State and local tax focus areas can include income tax, indirect tax, property tax, tax controversy, and more.

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