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The State of State and Local Taxation and How it Impacts Your Law Firm

Presentation to the Association of Legal Administrators

February 20, 2014

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Topics

- State Economics: The Chase for $'s
- Filing Requirements: Physical vs. Economic Nexus
- Revenue Sourcing: Cost of Performance vs. Market Based Sourcing
- Economic Nexus Trends: The State Freight Train
- Exposure: How States Identify Non-Filers?
- Compliance vs. Noncompliance: Firm vs. Partner/ Shareholder Costs
- Other Considerations: Payroll Implications
- Practical Considerations: What to Do?

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Today's State & Local Economic/ Taxation Climate

- States/Cities are having severe financial issues and desperate to find money:
  - Detroit files for bankruptcy,
  - Connecticut's legislature considered the sale of life insurance policies on its civil workforce for upfront cash,
  - Comparative - 2011 State Unfunded Pension Liabilities per Capita/(*Adjusted Net* Pension Liability):

CA	$3,206	($121,000,000,000)	**MA**	$6,770	($44,500,000,000)
CT	$11,595	($42,5000,000,000)	**NJ**	$7,156	($63,000,000,000)
IL	$6,505	($133,000,000,000)	**NY**	$1,132	($22,000,000,000)

Today's State & Local Economic/ Taxation Climate

- However, the current 2013 estimated gross unfunded liability for NYS's 2 largest retirement funds is 260B!

- NYC's unfunded liabilities as of 2009 estimated at 70.5B (healthcare), 44B (pension).

Why Focus on Nonresident Taxpayers

- State cannot do any better than taking money from taxpayers who don't vote!
- States are constantly looking to change their tax structures to bring in more $$$ without impacting residents who do vote.
- States do not discriminate – they go after PCs and LLPs for any $$$ they can obtain!
- States feel they are not getting their fair share.

Nexus (Filing Requirements)

- *Physical* Nexus: in general a connection, i.e. - minimum level of physical presence within a state that permits a taxing authority to require you to register and file tax returns:
  - Office
  - Attorneys performing services (client meetings, litigations & depositions, possibly solicitation of business)
  - (Telecommuters – 36 states plus DC & NYC have telecommuter rules; recent legislation)
  - Property, plant or equipment located within the state

Nexus (Filing Requirements)

- *Economic* Nexus: in general an economic connection, i.e. - having a minimum level of economic activity within a state that permits a taxing authority to require you to register and file tax returns:
  - Economic nexus was established for intangibles with Geoffrey, Inc. v. South Carolina (1992) which allowed the state to impose tax on the licensing revenue of the intangible Geoffrey the Giraffe licensed to the Toys *R* US chain by an out of state entity. Hence no physical presence was maintained as this was an intangible located within the state.

Nexus (Filing Requirements)

- Currently 31 states utilize the concept of Economic Nexus, of which 19 use Market Based Sourcing to apportion revenue! Many states treat corporations and unincorporated entities differently.

- The Multi State Tax Commission developed a *bright-line* test adopted by many states to determine if a company is economically present within a state by looking at the typical 3 factors of an apportionment formula:
    - Sales =/> $500,000 of sales are within the state
    - Property =/> $50,000 of property is within the state
    - Payroll =/> $50,000 of payroll is within the state

- Additionally, states may use a percentage (2-25%) of an apportionment factor within the state to create economic nexus the same as the $ amounts above.

Constitutional Issues

- Public Law 86-272 (1959) provides Constitutional protection only for the imposition of an income tax on the sale of tangible personal property. It does not protect companies engaged in the sale of services or against the imposition of a franchise taxes or the rash of non-income based taxes such as:
  - Texas Margin Tax (TMT)
  - Ohio Commercial Activities Tax (CAT) $509,500 sales, $50,950 Property/Payroll
  - Washington Business & Occupation Tax (B&O) $250,000 sales, $50,000 Property/Payroll
  - Delaware Gross Receipts Tax $100,000/Month

State Sourcing of Revenue

- Cost of Performance (CoP): this is the sourcing of revenue based upon either the direct costs incurred in the performance in that state, the location of the actual physical performance of services, or the location of the office the employee or partner works out of. There are generally 4 CoP methodologies determined by the state involved:

State Sourcing of Revenue

- CoP - *All or Nothing*:
  - The amount of the revenue included in the state's numerator of the sales factor is based upon the preponderance of services threshold,
  - If the greatest portion of the services rendered is performed within that state, then 100% of the revenue attributable to those services is included in the numerator,
  - If the greatest cost of service is performed in another state, than the numerator would have -0- receipts included,
  - It is not a 50% test, i.e. - if services were performed in 3 states at 40%/ 30%/30% and the 40% state is an all or nothing state, then 100% of the revenue would be apportioned there regardless of the other states,
  - Alaska, Indiana, Kentucky, Massachusetts (2013), New Hampshire, New Mexico, Oregon, Pennsylvania (2013), Vermont, Virginia and West Virginia.

State Sourcing of Revenue

- CoP - *Proportionate*:
  - The portion of the revenue included in the state's numerator of the sales factor is found by multiplying the revenue by a fraction, the numerator of which is the direct costs incurred in the performance in that state and the denominator of which is the direct costs incurred in the performance of that service everywhere.
  - Arkansas, Colorado, South Carolina.

State Sourcing of Revenue

- CoP - *Services Performed*:
  - The portion of the revenue included in the state's numerator of the sales factor is determined based upon the time spent working in the state and the receipts received for that time.
  - Florida, Idaho, Louisiana, Michigan, New Jersey (2013) North Carolina, Rhode Island, Texas, New York City, Delaware, Nebraska (2013).

- CoP - *Base of Operations*:
  - The portion of revenue included in the state's numerator is based upon the location of the office from which the employee performed the services regardless of where the services are performed.
  - Connecticut, New York.

State Sourcing of Revenue

- Market Based Sourcing (MBS): under the MBS methodology, in general, revenue from services are assigned to the state in which the customer is located however, each state may look at this and come to different conclusions based upon the facts and different factors they employ. Some states will use the following priority ordering rules (however, the definition of "market" varies substantially) to determine the sourcing:
  - The location at which the services are received
  - The location where the purchaser receives the benefit of the services
  - The location at which the services are used
  - The location of the customer
  - The location of the payor
  - The location where the service is performed
  - The location of the use of the intangible

State Sourcing of Revenue

- California uses the following rules (Reg. 25136-2):
  - Where the contract indicates the benefit is received
  - If the contract doesn't provide the location, then it may be reasonably approximated
  - If neither of the above provide the location, the receipts are sourced to the state from where the customer placed the order
  - If none of the above provide the location, the receipts are sourced to the state of the customers billing address
- Still other states use different parameters to determine the market.

The Trend is Clear

The trend towards MBS has been growing (Note - some states may be Corporate only):

Minnesota (1987)
Georgia
Iowa
Maryland
Ohio (2004)
Wisconsin (2005)
Maine (2007)
Michigan (2008)
Illinois (2009) *need physical presence*
Utah (2009)
Oklahoma (2010)
Washington (2010)
Alabama (2011) *out of state credit card banks only*
California (2011, 2013)
Arizona (2014)
Massachusetts (2014)
Nebraska (2014) *corporate only*
New Jersey (proposed 2014) *corporate only*
Pennsylvania (2014) *corporate only*

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The Trend is Clear

- Most states will only use a single receipts factor for apportionment.

- With states employing different methods (CoP vs. MBS) and different definitions and rules within the same methods, for firms operating in multiple jurisdictions these rules can hurt firms by creating allocations significantly over 100%!

The Search for Tax Revenue

How States Identify Non-Filers

- Business Audits:
  - 1099-Misc – issued to out of state firms, there is no way for the state to know whether any income was earned within the state,
  - State issuance of nexus questionnaire or in some instances assessments issued,
  - Representing state agencies may require filing with the state to do business.

The Search for Tax Revenue

- Court Docket Searches:
  - States will conduct searches of court records to determine out of state attorneys/firms that were physically present but returns not filed.
  - Some states require filing fees for appearances even if representation is pro hac vice, e.g. – CT.

The Search for Tax Revenue

- Internet Searches:
  - States will hire independent contractors to perform internet searches, typing in the name of the state into the law firms website search engine to find:
    - Attorneys with licenses in the state (failure to file can be grounds for suspension or even revocation of licenses in most states),
    - Firms trumpeting litigation victories where the court was located within the state,
    - Deals done for clients within the state.

Cost of Compliance Vs. Non-Compliance

- Compliance:
  - Administrative burden of tracking/developing the information.
  - Getting timekeepers to properly report.
  - Proper case/matter intake, etc.

- Costs:
  - Staffing for the increased administrative burden.
  - Entity level returns.
  - Partner composite or individual returns.
  - Estimated/withholding tax filings.

Cost of Compliance Vs. Non-Compliance

- PC vs. LLP:
  - Shareholders of a "C" Corp. PC file based upon where their W-2 compensation is earned.
  - Partners of an LLP (and shareholders of an "S" Corp. PC) file based upon where the firm's income is earned.

- Non-Compliance
  - Nonresident State - No statute of limitations – NJ went back 10 years via court dockets in early 2000's.
  - Resident State - Refund claims could be barred by statute as generally 3 years to claim refund.

Other Considerations

- Employment Issues:
  - For apportionment purposes, payroll is generally sourced based upon where unemployment is paid.
  - Withholding could be required on employees performing services in nonresident states requiring both registration by the firm for payroll taxes and causing employees to have to file personal returns in those nonresident jurisdictions.

Practical Considerations

- Understand the issues, costs and consequences.
- Make sure the information intake or methodology to develop the information is good enough to provide data necessary to make tax/business decisions.
- Develop risk/business parameters that your firm can live with.
- Every firm regardless of whether a PC or LLP is different.
- Do not forget about the reputational risk to the firm of not doing the right thing.

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