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Accountants & business advisers

These are frightening times for small business.

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. With budget woes approaching crisis point across the country (witness California's well-publicized meltdown), state treasuries are stretched painfully thin.

Highway Robbery?

In response to their 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, agencies are cooperating across multi-state areas, leaving no leaf unturned.

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 auditors. There is also the very real threat of punishing tax legislation from state legislatures.

For example, Massachusetts has made the move to unitary filing, requiring companies to consolidate all of their business units or affiliated companies and report combined income in the state if any single unit conducts business there. By considering companies as a single entity, taxing authorities feel they can prevent businesses from shifting income into low- or no-tax states. Vermont, New York, West Virginia and Wisconsin also recently made the move, while other states are scrambling to institute new taxation schemes based on gross receipts.

To top it all off, states are tightening the noose on the definition of nexus — the legal term for a taxable presence in a jurisdiction.

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.

A Mistaken Sense of Safety

The longstanding view is that only companies that maintain a physical presence in a state have nexus there. Many companies have mistakenly clung to protections afforded by Public Law 86272, a 1950s-era federal statute that prohibits states from taxing the income of an out-of-state business that is soliciting sales there.

Unfortunately, the law only applies to sales of tangible personal property and doesn't apply to sales tax. Nor 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.

Recent state supreme courts rulings have even held that catalog sales in another state can constitute economic nexus and trigger taxation. Ditto for companies who solicit out-of-state credit-card holders. 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.

Are You a Target?

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.

Small and midsize businesses are typical targets, as 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 they do business in.).

Depending on the state (Washington is particularly broad in its application of nexus), you could be considered to be doing business there (and subject to taxation) based on any number of seemingly innocent activities.

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.

Much more common is the routine business activity questionnaire that winds up in your company mail and is ignored (or, worse, the wrong person within the company responds and provides inappropriate answers).

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 accounting professional can provide invaluable guidance and help formulate an appropriate response to state revenue authorities. This typically includes a thorough risk analysis, including 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 CPA 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 contact your PKF California advisor.