CFO

THE TAX MEN COMETH

BESET BY PLUNGING REVENUES, STATES STEP UP THEIR PURSUIT OF CORPORATE TAXES.

BY KATE O'SULLIVAN

A small furniture manufacturer based in Arizona recently received a nexus survey—a questionnaire about the company's business activity—from the state of Washington. With just two retail customers in the Evergreen State and a lone sales rep making an annual visit there, the Arizona company returned the form and thought that was the end of the matter. No such luck. Washington ►

assessed the Arizona furniture manufacturer "a substantial income tax," according to Marvin Kirsner, a tax attorney with Greenberg Traurig who represents the company. "One salesperson was there for a total of three days over four years. That was all it took."

State budgets, which seem to flirt with disaster even in good times, are now in dire straits, and that has big implications for business. Plunging tax revenues now have more than 40 states facing budget shortfalls, and as many as 10 (including California, Florida, and New York) expect fiscal 2010 revenues to lag expenses by more than 20%, according to Harley Duncan, a managing director in the state and local tax practice at KPMG. To fill in the budget gaps, states are aggressively seeking more business-tax revenue via corporate income taxes, stepping up enforcement, interpreting nexus more broadly, and proposing additional business levies.

The 2009 *CFO* State Tax Survey, conducted with KPMG, shows that companies are bracing for the increased attention. Corporate tax directors expect many state legislatures—particularly California, New York, Illinois, New Jersey, and Massachusetts—to be very aggressive in their efforts to close budget gaps through additional corporate taxation and tax enforcement. (See charts, pages 3–4.)

"The states are in an extremely difficult financial condition," says Kirsner. "They pretty much have three choices: they can cut their spending; they can pass tax increases, which don't make citizens very excited; or they can increase their enforcement efforts to raise [tax] revenues that have been lost."

SMALL COMPANIES BEWARE

Companies can count on that third option. New York, for example, plans to raise $2.5 billion for its state budget from tax audits, according to McDermott Will & Emery attorney Peter Faber. "We're seeing an intensification of audit activity for corporations, which is where I think the states feel the big money is," he says. "And it's not just in New York." Kirsner predicts that small and midsize businesses will be the first to field surprise visits from state revenue authorities. "Smaller businesses don't have big tax departments, and they don't want to pay the fees for someone to do reviews of all the different states that they do business in," he notes.

As that Arizona furniture maker learned, states are also stepping up efforts to establish nexus, the legal term for a taxable presence in a jurisdiction. Experts say tax authorities are actively targeting companies that have been doing business in their state but have not been filing either corporate income tax returns or sales tax returns.

Kirsner advises finance executives to consult with a tax professional before responding to a state's nexus survey,

Brian Smith

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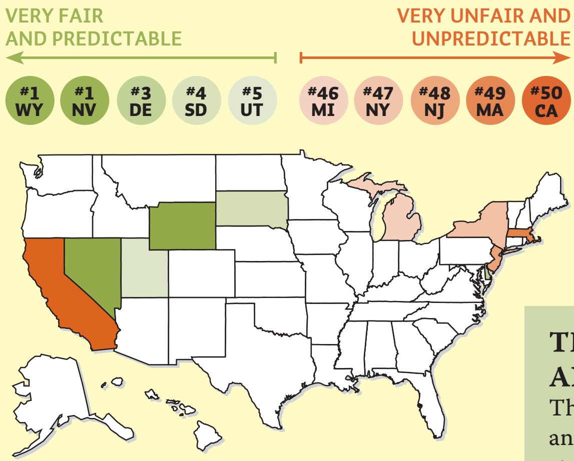
even if they feel certain they have no tax liability in the state. Many companies may believe they are protected by a federal statute that says a state cannot impose income taxes on a company that is in the state simply to solicit sales. But as Kirsner points out, the statute doesn't apply when a company is selling services. Nor does it apply when sales tax is involved, or when a state has a gross receipts tax instead of a corporate income tax, as Washington, Texas, Michigan, and Ohio do. In such cases, "Once you respond [to a nexus survey] and admit in writing that you were there soliciting sales, then the question becomes, How much were you there? In the state of Washington, one day is enough," says Kirsner.

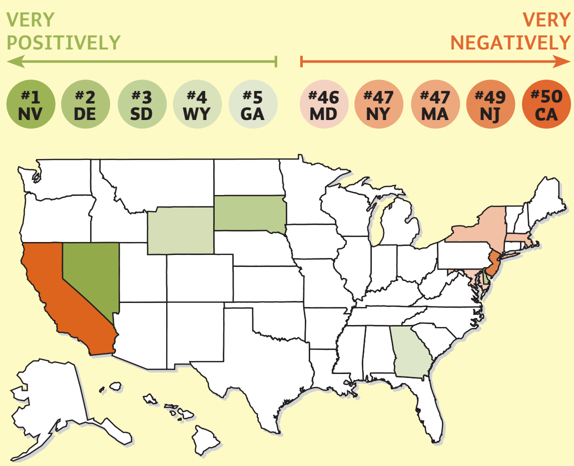
Recent court cases may make nexus even harder to avoid. While companies once were thought to have nexus only if they maintained a physical presence in a state, state supreme courts have held that conducting business in a state—through catalog sales, trademark licensing, or the solicitation of credit-card holders—can constitute so-

THE BEST AND WORST
The charts on this page and the next highlight states ranked best and worst on six key measures. For more, see www.cfo.com/statetax.

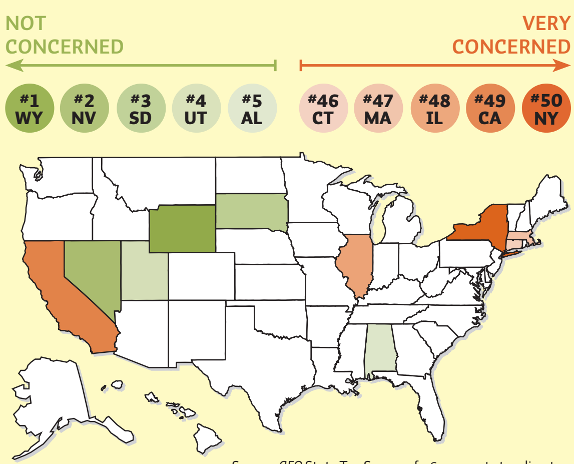
① What is your overall impression of the tax environment in each state?



② How do each state's revenue department policies and systems influence your company's decision to locate or expand there?



③ How concerned are you that your state's fiscal condition will negatively affect your company in some way in the next 12 months?



Source: *CFO* State Tax Survey of 116 corporate tax directors

called economic nexus and subject a company to tax. In the recent case of *Amazon* v. *New York*, an Empire State trial court ruled that if an Internet retailer generates at least $10,000 worth of sales through referral agreements in New York in a given year, it has nexus and must collect and remit New York sales tax. Amazon.com will likely appeal the decision, but in the meantime, other states, including Illinois and California, are considering adopting New York's approach.

In Massachusetts, the state supreme court is considering a case in which a regional tire retailer is arguing that it does not have to collect use tax on tires sold in New Hampshire—the Bay State's sales-tax-free neighbor—to Massachusetts residents. Massachusetts tax authorities contend that the retailer knew those customers intended to use the goods in Massachusetts, and should have charged a 5% tax and remitted the resulting monies to the Massachusetts Department of Revenue. If the state prevails, the ruling may affect other chain retailers with outlets in both states.

The last time the U.S. Supreme Court weighed in on nexus issues was in 1993, and it has indicated that any further action on the issue should come from Congress. Legislation regarding nexus has been introduced in the House, but it is unclear when or whether it will move forward. As a result, "the state courts are not getting any guidance, so they're just saying we'll do what we think is right," says Kirsner.

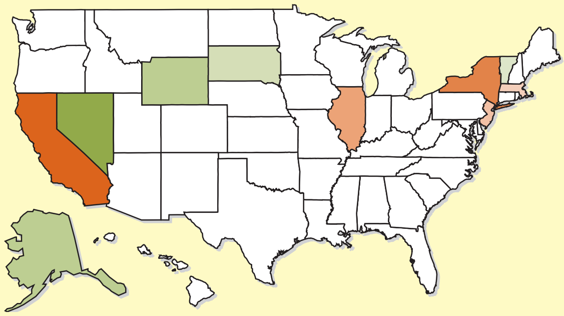
AUDIT THYSELF

ANOTHER APPROACH GAINING FAVOR WITH state revenue departments is to require unitary reporting, in which companies must consolidate all their business units or affiliated companies and report their combined income in the state if any single unit conducts business there. The state can then levy a tax on that income based on a formula that varies by state, but typically considers the proportion of the company's sales, property, and personnel in the state relative to its overall business. "It's a way of bringing out-of-state business into your web," says Faber.

Massachusetts is moving to unitary filing this year, says Paul Beecy, a Boston-based partner with Grant Thornton. Historically, states east of the Mississippi have used single-entity or some form of combined reporting, with every parent or sister company filing its own return, while those west of the Mississippi have generally taken the unitary approach. Now, a number of eastern states are considering unitary filing, says Beecy. Besides Massachusetts, Vermont, New York, ④ In the next 12 months, how aggressive do you expect each state to be in its efforts to close its budget gap (if one exists) through additional corporate taxation?

NOT AGGRESSIVE ← → VERY AGGRESSIVE

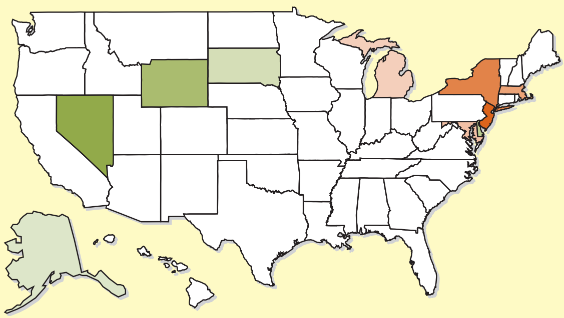
#1 NV · #2 AK · #3 WY · #4 SD · #5 VT · #46 MA · #47 NJ · #48 IL · #49 NY · #50 CA



⑤ How would you rate each state's stance on asserting nexus positions for corporate income tax over corporations with only an economic presence in a state?

NOT AGGRESSIVE ← → VERY AGGRESSIVE

#1 NV · #2 WY · #3 DE · #4 SD · #5 AK · #46 MI · #47 MD · #48 MA · #49 NY · #50 NJ



⑥ How would you rate each state's stance on asserting sales/use tax nexus?

NOT AGGRESSIVE ← → VERY AGGRESSIVE

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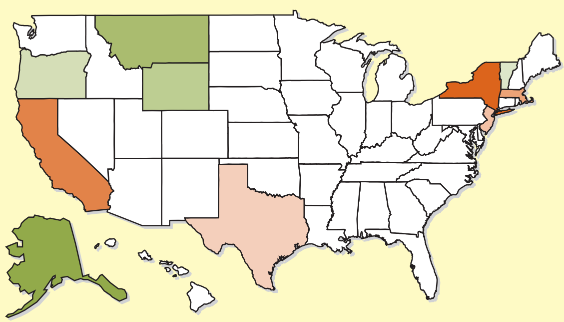

"STATES ARGUE THAT BY CONSIDERING COMPANIES AS A SINGLE ENTITY, YOU AVOID SITUATIONS WHERE COMPANIES CAN SHIFT INCOME AROUND INTO A LOW-TAX OR NO-TAX STATE."

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MANAGING DIRECTOR AT KPMG

and West Virginia have moved to unitary reporting, while Maryland is starting to gather data from companies about what their filings would look like on a combined basis.

"States argue that by considering these companies as a single entity, you avoid situations where the companies can shift income around into a low-tax or no-tax state," says KPMG's Duncan. Implementation poses a challenge for corporate tax departments, as each state approaches unitary filing slightly differently.

The move to unitary filing does not necessarily raise a company's tax bill in any given state, notes Beecy. "Let's say you've had a very profitable business in Massachusetts. What unitary filing means is you're pulling into the tax base not only the income of non-Massachusetts subsidiaries, but also the losses," he says. Of course, the hope for states moving to the unitary system is that they get a percentage, however small, of a much bigger pie.

Federal stimulus funds aside, states' finances are unlikely to improve any time soon. Companies should therefore prepare for tougher scrutiny from tax auditors and creative tax legislation from state legislatures. Tax directors should conduct thorough self-audits, advises Kirsner, looking at every part of the company—everywhere the business has customers, offices, and full- or part-time sales reps. "Do your own review before the state tax authority does it for you," he says. **CFO**

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