

State and local taxes

Businesses should monitor the tax laws and policies in the states in which they do business to understand their tax obligations, identify ways to minimize their state tax liabilities, and eliminate any state tax exposure. The following are some of the state-specific areas taxpayers should consider when planning for their tax liabilities in 2022 and 2023:

Nexus rules

- ☐ Has the business reviewed the nexus rules in every state in which it has property, employees or sales to determine whether it has a tax obligation? State nexus rules are complex and vary by state. Even minimal or temporary physical presence within a state can create nexus, e.g., temporary visits by employees for business purposes; presence of independent contractors making sales or performing services, especially warranty repair services; presence of mobile or moveable property; or presence of inventory at a third-party warehouse. In addition, many states have adopted a bright-line factor-presence nexus threshold for income tax purposes (e.g., \$500,000 in sales). Also keep in mind that foreign entities that claim federal treaty protection are likely not protected from state income taxes, and those foreign entities that have nexus with a state may still be liable for state taxes.
- ☐ Has the business considered the state income tax nexus consequences of its mobile or remote workforce, including the impacts on payroll factor and sales factor sourcing? Most states that provided temporary nexus and/or withholding relief relating to teleworking employees lifted those orders during 2021. (Also see *Considerations for employers*, above.)
- ☐ Does the business qualify for P.L. 86-272 protection with respect to its activities in a state? For businesses selling remotely and that have claimed P.L. 86-272 protection from state income taxes in the past, how is the business responding to changing state interpretations of those protections with respect to businesses engaged in internet-based activities?

Filing methods and elections

- ☐ Is the business using the most advantageous filing method allowed by a state based on its facts and circumstances? States may require or allow a taxpayer to report on a separate company or unitary combined reporting basis, or may provide filing option elections. A state's mandatory unitary combined filing may allow a "water's edge" election or a worldwide combined group election. States have different rules for how and when to file water's edge and other reporting method elections; therefore, care should be taken that the election is filed on a timely basis.
- ☐ Where the taxpayer or a U.S. affiliate has foreign activities, or where the taxpayer has foreign affiliates, have the overseas business operations been evaluated as to whether they should be included in any water's edge unitary combined group?
- ☐ If the business' affiliated group has both loss entities and profitable entities, has the business considered making nexus consolidated return elections in states where such elections are allowed?

- ☐ Did the business make an S corporation election for federal income tax purposes, and is it required to make a separate state election (or file nonresident shareholder consents with the tax jurisdiction)?
- ☐ Does the business operate using single member LLCs or other federal disregarded entity structures, and has the tax treatment of those structures been reviewed for state-specific rules and filing requirements?

Taxable income and tax calculation

- ☐ Does the state conform to federal tax rules or decouple from them? Not all states follow federal tax rules. For example, many states have their own systems of depreciation, and may or may not allow federal bonus depreciation.
- ☐ Where the business receives deductible dividends, GILTI, subpart F income, or other nontaxable income, have state expense disallowance attribution rules been applied?
- ☐ Does the business have intercompany royalty or other intangible expense, interest expense, or management fees paid to a related entity that may be required to be added back in computing state taxable income?
- ☐ Has the business claimed all state NOL and state tax credit carrybacks and carryforwards? Most states apply their own NOL/credit computation and carryback/forward provisions.
- ☐ Is the business claiming all available state and local tax credits? States offer various incentive credits including, e.g., for research activities, expanding or relocating operations, making capital investments or increasing headcount.

Allocation and apportionment

- ☐ Is the business correctly sourcing its sales of tangible personal property, services, and intangibles to the proper states? The majority of states impose single-sales factor apportionment formulas and require market-based sourcing for sales of services and licenses/sales of intangibles using disparate market-based sourcing methodologies.
- ☐ Has the business considered whether a nonbusiness or allocable income position may be appropriate and whether taking such a position would be advantageous?
- ☐ If the business holds an interest in a partnership, have the consequences with respect to factor flow-through and other potential special partnership apportionment provisions been considered?
- ☐ If the taxpayer sold assets or a business segment, including where an IRC Section 336, 338(g), or 338(h)(10) election was made, has the multistate treatment of the sale gain receipts been addressed, including with respect to goodwill?
- ☐ If the business is a manufacturer, retailer, transportation company, financial corporation, or other special industry, have state special apportionment elections or required special apportionment formulas been considered?

Other issues

- Has the business considered the state and local tax treatment of merger, acquisition and disposition transactions? Keep in mind that internal reorganizations of existing structures also have state tax impacts. There are many state-specific considerations when analyzing the tax effects of transactions.
- Has the business considered state and local transfer pricing requirements with respect to its intercompany financing and other intercompany arrangements? With rising interest rates and inflation, intercompany arrangements should be re-addressed, and intercompany transfer pricing studies may need to be updated. Also see *Transfer Pricing*, above.
- Has the business amended any federal returns or settled an IRS audit? Businesses should make sure state amended returns are filed on a timely basis to report the federal changes. If a federal amended return is filed, amended state returns may still be required even when there is no change to state taxable income or deductions.

State pass-through entity elections

The TCJA introduced a \$10,000 limit for individuals with respect to federal itemized deductions for state and local taxes paid during the year (\$5,000 for married individuals filing separately). Nearly 30 states have enacted workarounds to this deduction limitation for owners of pass-through entities, by allowing a pass-through entity to make an election (PTE tax election) to be taxed at the entity level. PTE tax elections present complex state and federal tax issues for partners and shareholders. Before making an election, care needs to be exercised to avoid state tax traps, especially for nonresident owners, that could exceed any federal tax savings.

Other state and local taxes

State and local property taxes, sales and use taxes and other indirect state and local taxes can be the largest piece of an organization's state tax expenditures, even exceeding state and local income and franchise taxes. Just like state income taxes, businesses should understand and plan for their other state and local tax obligations. Some areas of consideration include:

- Has the business reviewed its sales and use tax nexus footprint, the taxability of its products and services, and whether it is charging the appropriate sales and use tax rates? A comprehensive review of the sales and use tax function along with improving or automating processes may help businesses report and pay the appropriate amount of tax to the correct states and localities.
- Remote retailers, marketplace sellers and marketplace facilitators (i.e., marketplace providers) should be sure they are in compliance with state sales and use tax laws and marketplace facilitator rules.
- Assessed property tax values typically lag behind market values. Businesses should consider challenging their property tax assessments within the applicable appeal window.
- Businesses should ensure they are properly reporting and remitting unclaimed property to state governments. All 50 states and the District of Columbia require holders to file unclaimed property returns.