

# State and local tax year-end planning and strategic considerations

Take these steps to build resilience and promote tax-efficient operations

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## EXECUTIVE SUMMARY

State legislatures faced a growing number of budget shortfalls to begin fiscal year 2025 as lower tax collections and a slowing economy curtailed the pandemic-era revenue boom. However, tax increases were rarely in the discussion. Budgets were balanced, and some states still have managed to cut taxes. The full economic landscape remains uncertain as 2025 approaches, and the states will likely remain cautiously optimistic about revenue forecasts.

Regardless of what occurs in statehouses, taxpayers need to prepare for both unforeseen economic changes and the potential for federal tax reform in the next presidential administration to trickle down to the states. Being audit-ready and focusing on cash flow are time-tested methods to approach uncertainty. Preparation is key.

Below, we address year-end state and local tax planning optimization strategies that may help businesses maintain compliance, leverage opportunity and prepare for uncertainty.

## GENERAL CONSIDERATIONS

### Gross receipts taxes review

Several states have adopted state-level gross receipts taxes, including Delaware, Nevada, Ohio, Oregon, Tennessee, Texas and Washington. These taxes are imposed on the gross receipts of a business without regard to profit or loss. In some states, the gross receipts tax is imposed in addition to corporate income and franchise taxes.

The tax generally applies to receipts generated from sales within the state. Out-of-state businesses are often unaware they are incurring gross receipts tax liabilities. At the local level, cities in California, Washington and many other states also impose gross receipts taxes, and more are considering them.



In addition to increasing the tax burden, gross receipts taxes often bring new reporting and compliance obligations. Businesses should consider assessing the following factors for gross receipts tax exposure:

1. The number of sales or existence of physical presence in the listed states
2. Whether the state has a threshold for a business to either file or be subject to the gross receipts tax
3. Classification of receipts into appropriate activity categories
4. Availability of deductions, exclusions or entity exemptions

## Nexus review

Businesses should consider whether nexus has been established as it relates to all types of state tax. State revenue departments are scrutinizing the in-state activities of remote businesses, especially in the context of economic nexus, and audits and questionnaires have increased significantly.

For sales tax and income tax, the U.S. Supreme Court issued its decision in *South Dakota v. Wayfair* in 2018, overturning the physical presence nexus standard established in 1992 through *Quill v. North Dakota*. Accordingly, states may impose sales and use tax collection and remittance responsibilities on remote sellers based solely on their economic presence in a state.

Most states have long taken the position that companies are subject to income and franchise taxes even without maintaining a physical presence in their jurisdictions. But in the post-*Wayfair* era, states have become more focused on activities that produce economic nexus for income and franchise tax purposes. Businesses need to be aware of laws and regulations that can minimize their exposure to taxes, such as Public Law 86-272, which provides nonbusiness income allocation and factor-presence standards.



Nexus should be carefully considered at least on an annual basis, especially if a taxpayer is entering new markets or sales jurisdictions. Consider the following for general nexus determinations:

1. The sales, property or payroll in a state where the business is not currently filing
2. The number of sales and total sales amounts for each state for sales and use tax nexus purposes
3. Expansion due to capital investment or hiring in new jurisdictions, or the intent to expand and increase expenditures
4. Past, current, and future merger and acquisition activity

## Credits and incentives opportunity and compliance review

The states offer some variation of statutory or discretionary credits and incentives opportunities in almost any economic climate. During a slowing economy, taxpayers should consider leveraging existing, renegotiated or new incentive programs to maximize cash flow. Incentives are broadly available for hiring, training and capital investment.



Taxpayers may have difficulty understanding how to approach credits and incentives. The following are important considerations:

1. Review current and future expansion plans. Taxpayers considering relocation, large capital investment or increased hiring should understand the wide availability of incentives in current locations as well as in potential locations.
2. Review incentive programs already in place to confirm fulfillment of all compliance and performance requirements and mitigate the risk of clawbacks.
3. Evaluate current statutory incentives for opportunities to maximize benefits. Some states allow retroactive claims for statutory benefits.

## Digital assets

Implementation of digital assets recorded on the blockchain has grown exponentially in the past decade. Individuals and businesses are using digital assets, such as cryptocurrency, to buy goods and services. Non-fungible tokens (NFTs)—unique digital assets representing a contract right for art, admissions and documents, among other items—are being sold, traded or used for numerous other purposes.

Selling, buying, investing or trading digital assets may raise numerous state and local tax questions involving sourcing, apportionment, taxability, structuring and planning. With states largely silent on many of those questions, due diligence is necessary for determining state and local tax exposure.



Purchasers and sellers of digital assets, as well as digital asset marketplaces, should evaluate the following:

1. State guidance or special rules around income derived from cryptocurrencies
2. Structuring opportunities and planning to reduce state tax exposure
3. General state reporting requirements for holding and selling cryptocurrencies
4. Indirect (sales and use tax) taxation of NFTs

## SALT controversy

State and local tax controversy is a growing risk for taxpayers. States are again turning to enhanced enforcement to capture additional revenue. Businesses must be proactive in mitigating and resolving potential controversies or disputes with state and local taxing authorities for prior, current or future tax years. Understanding audit triggers, creating a plan to address audits and notices, documenting positions and understanding risk will help manage any potential controversies.



Businesses should consider the following questions:

1. Is there a plan in place to address notices, questionnaires, audits and other taxing authority communication?
2. Are positions properly documented?
3. Has exposure been documented and quantified in order to explore mitigation through voluntary disclosure, amnesty or other mechanisms?
4. Has the business considered private letter rulings for issues of unclear tax treatment?

## INCOME AND FRANCHISE TAX PLANNING CONSIDERATIONS

### Public Law 86-272

The Interstate Income Act of 1959, commonly known as P.L. 86-272, generally prohibits states from imposing net income taxes on income derived from interstate commerce if the business activities in the state are limited to solicitation of orders of tangible personal property that are sent outside the state for approval and, if approved, are filled by shipment or delivery from a point outside the state.

States have increased audits of businesses taking P.L. 86-272 positions. In addition, the Multistate Tax Commission unanimously adopted an update of its PL 86-272 guidance specifically to address internet activities. This new guidance generally provides that interaction between a business and its customer via the business's website or app is business activity in the customer's state for the purposes of applying P.L. 86-272 and will be treated as exceeding protected activities to the same extent that such interactions would be unprotected if done in person.

The guidance provides a carve-out for websites and apps that limit interaction to static text or photos; however, websites and apps have long been trending away from this narrow exception. While only a few states have adopted the new guidance, many more are expected to in the future.



If you are currently taking or considering a P.L. 86-272 position, the following steps are critical:

1. Reviewing current P.L. 86-272 positions for accuracy and potential exposure to the revised guidance
2. Understanding the business's current multistate activities conducted over the internet
3. Tracking early adoption of the new guidance by states like New Jersey and New York
4. Developing an action plan for when additional states begin to adopt the revised position

### Sourcing review

For sales other than sales of tangible personal property, states may use a variety of methods to determine where revenue should be sourced. Over two dozen states have adopted market-based sourcing rules for services, replacing the traditional cost-of-performance sourcing rules.

Market-based sourcing looks to the location of the customer. However, the states take different approaches to determining the market, including considering where the services are delivered, received and billed. Many states continue to utilize some form of cost-of-performance sourcing, though many states that do so may interpret these rules to source sales to the customer's location, effectively arriving at a conclusion similar to that of market-based sourcing. Companies that do not analyze these different approaches often overstate or understate their sales factors.



Consideration should be given to the following:

1. Sourcing of intangible items, include gains on stock or partnership interests
2. Taxing department interpretation of sourcing rules
3. Potential for business gains from business or interest sales
4. A sourcing review for when large numbers of jurisdictions or multiple material jurisdictions are involved

## Apportionment review

State revenue departments are scrutinizing business apportionment methods more closely than ever. For multistate companies, particularly those with more than one business line, complying with myriad apportionment rules can be a complex administrative burden. Further, many states have industry-specific apportionment formulas that are either required under statute or available through special election for qualifying taxpayers. Correctly identifying the required apportionment method and the income subject to apportionment and allocation could save substantial amounts of income and franchise taxes.



Before year-end, it is important to do the following:

1. Extrapolate estimated apportionment data from the previous four quarters to identify key positions for which the company will need specific, highly detailed data for its returns.
2. Analyze whether the business can obtain more favorable apportionment by restructuring its legal entity structure or business operations.
3. Review opportunities to make special or industry-specific apportionment elections.
4. Evaluate whether special or alternative apportionment could more fairly reflect a business's activity than the respective state's standard apportionment methodology.

## State income tax refund review

Many taxpayers have open periods in which they've taken conservative positions on state and local income and franchise tax filings. These positions can result in significant overpayments of income tax, especially when the positions are not reviewed in a timely manner.



Taxpayers should consider reviewing positions following:

1. Changes in the business's facts or circumstances
2. Changes in state or local statutory or regulatory law
3. A significant number of state tax notices
4. New or amended guidance that may have materially changed or mitigated the previous positions

## Unitary review

Depending on the circumstances, filing state income tax returns on a mandatory combined basis can be either beneficial or detrimental to taxpayers. The business should determine whether it has the control, integration and flow of value required to establish unity and should model state income taxes on both a separate and combined basis to evaluate the exposure or benefit between the two filing positions.

Where sufficient value exists, it may be advisable to take steps to break or create unity. This analysis is particularly important if the company has completed, or is going to complete, a major acquisition or disposition of entities or assets during the tax year. When a corporation acquires another corporation (or corporate group), the issue often becomes not whether the acquired corporation(s) is unitary, but rather when it becomes unitary. This is important for several reasons:

1. Tax compliance and determining how the returns are filed
2. The use of losses or other tax attributes that may expire
3. The use of depreciation or amortization as a result of a step-up in the basis of assets

# SALES AND USE TAX PLANNING CONSIDERATIONS

## Sales and use tax process review

Sales and use tax compliance can be a complex function affected by and impacting numerous areas of business operations and accounting. Over time, business operations change and must adapt to growth into new markets, the expansion of products and services, employee turnover and, often, a lack of multistate tax expertise on staff.

If not frequently addressed, internal sales and use tax compliance processes can become disconnected from business activities and current tax law. As a result, businesses may be under- or over-reporting sales and use tax, which creates tax compliance risk and may cause a competitive disadvantage in situations where fully compliant competitors are able to charge less for the same products or services.

Process reviews can help a business better assess the following:

- The current business processes and technology platforms that support all aspects of the indirect tax function
- The potential areas of exposure or opportunities for tax refunds based on current practices
- Process-related improvements to help mitigate risk and maximize compliance



Process reviews are ideal for taxpayers that:

1. Have never reviewed the internal sales and use tax process
2. Are experiencing growth, expansion or turnover
3. Have a history of unfavorable sales and use tax audit assessments
4. Are implementing or upgrading enterprise resource planning systems

## Reverse sales and use tax audits

Businesses in the middle market routinely overpay sales taxes and over-accrue use taxes, often because they maintain smaller tax departments that lack sales and use tax expertise and experience. Frequent changes in sales and use tax laws and regulations result in quickly outdated tax decision matrices and tax rates for businesses that do not employ an enterprise tax rate solution or other necessary compliance procedures.

Reverse sales and use tax audits can identify and recover sales and use tax overpayments and identify lapses in a company's associated compliance process. Certain industries—including manufacturing, construction, large retail, health care (e.g., hospitals), public utility and agriculture—are more likely to have significant refund opportunities due to underutilization of available exemptions.



Reverse audits may benefit taxpayers that:

1. Have multistate locations or high volumes of purchases
2. Are currently undergoing or recently underwent a sales and use tax audit
3. Are planning or have engaged in mergers and acquisitions activity
4. Have never performed a taxability review
5. Are implementing new enterprise resource planning systems or accounts payable modules

## Digital goods and services review

The states in recent years have moved further away from a uniform approach to the taxation of digital goods and services. More recently, new and novel digital taxes have emerged, such as data taxes and taxes on digital advertising.

As businesses create new products and services, the risk of incorrect compliance or noncompliance increases. The application of a state's sales and use tax to a sale or purchase of digital goods and services depends on:

- The characterization of that good or service for sales and use tax purposes
- How the state sources the sale or purchase
- Whether the transaction is taxable

Understanding the complex interplay between operations and tax is key to making the right determinations and collecting and remitting the appropriate amount of sales tax or paying the appropriate amount of use tax to the right jurisdictions.



Consider the following:

1. Has your business created new digital or cloud revenue streams?
2. Have you performed a multistate taxation review of digital services or have prior reviews been updated to account for changes in the business?
3. Have you considered overpayments or over-accruals of sales and use tax on digital services and products?

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