Executive summary

State legislatures were once again in full swing in 2023, but the story of near-universal state surpluses from the last two years has reached its denouement. Cracks have begun to show in the fiscal foundation of state budgets, as tax revenues saw the first signs of declining growth—but not among all states or taxes.

Still, many states continued tax cuts. While the fiscal environment remains unclear, taxpayers should prepare for decreased tax revenue growth over the next couple of years. Less revenue may provide states an opportunity to revisit tax base or tax rate increases. Preparation is key.

Importantly, state taxpayers are never without planning opportunities. Below we address a number of potential focus areas that should be considered for year-end state and local tax planning depending on a taxpayer’s facts and circumstances. Many of these topics create risk for taxpayers who ignore them completely and opportunity for taxpayers who plan ahead.

Nexus review

Nexus is most often considered in the context of determining whether a business has established sufficient contacts to be required to file state or local tax returns. However, the question of where a company must file only scratches the surface of the importance of determining nexus.

Businesses should consider whether nexus has been established among all state tax types. State revenue departments are increasingly scrutinizing the in-state activities of remote businesses, especially in the context of economic nexus.

For sales tax and income tax, the U.S. Supreme Court issued its decision in South Dakota v. Wayfair in 2018, overturning the long-standing physical presence nexus standard established through Quill v. North Dakota in 1992. With the Wayfair decision, the court has allowed for the possibility for states to impose sales and use tax collection and remittance responsibilities on remote sellers based solely upon 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 a 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 PL 86–272, nonbusiness income allocation and factor-presence standards.

Careful consideration should be given to nexus at least on an annual basis. Consider the following for general nexus determinations:

- The sales, property or payroll in a state where the business is not currently filing
- Maintenance of a real-time system to track the number of sales and total sales amounts for each state for sales and use tax nexus purposes
- Expansion from capital investment or hiring into new jurisdictions, or the intention to expand and increase expenditures
- Past, current and future merger and acquisition activity
Public Law 86–272

The Interstate Income Act of 1959, commonly known as Public Law 86–272 or PL 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.

On Aug. 4, 2021, the Multistate Tax Commission (MTC) unanimously adopted an updated version 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 PL 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.

If you are currently taking or considering a PL 86–272 position, the following steps are critical:

- Reviewing current PL 86–272 positions for accuracy and potential exposure to the revised guidance
- Understanding the business’s current multistate activities conducted over the internet
- Tracking the early adoption of the new guidance from large states like California (the first state to adopt the guidance) and New York
- Developing an action plan for when additional states begin to adopt the revised position

Gross receipts taxes review

Seven states have adopted some form of gross receipts taxes (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 that 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 these taxes every year.

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

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

Apportionment review

State revenue departments are scrutinizing business apportionment methods more closely than ever before. 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.

State transfer pricing review

Many states have begun conducting intensive transfer pricing audits of businesses with significant intercompany transactions. The number of audits has quadrupled in recent years, and many states are in the process of hiring more transfer pricing auditors and specialists. Moreover, many states have contracted with outside economic and legal experts to pursue suspected transfer pricing violations.
These audits often lead to substantial tax adjustments, consume an inordinate amount of taxpayer resources and result in prolonged litigation. Taxpayers should be proactive when it comes to state transfer pricing audits.

Consider these questions:

- Are there significant amounts of intercompany transactions?
- Has the company commissioned a transfer pricing study?
- How does the state conform to federal transfer pricing rules?
- Do the subject transactions have economic substance, i.e., a business purpose?
- Are related party expenses subject to add back for state purposes?

State income tax refund review

Many taxpayers have open periods with conservative positions taken 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 timely.

It is important that taxpayers consider reviewing positions following:

- Changes in the business’s facts or circumstances
- Changes in state and local statutory and regulatory law
- 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.

It is important to determine whether the business has the control, integration and flow of value required to establish unity and to model state income taxes on a separate and combined basis. 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:

- Tax compliance and determining how the returns are filed
- The use of losses
- The use of other tax attributes that may expire
- Use of depreciation or amortization as a result of a step-up in basis of assets
Credits and incentives compliance review

Credits and incentives compliance can be complex. During times of economic distress, taxpayers should consider leveraging existing, renegotiated or new incentive programs to maximize cash flow during periods of high interest rates and general economic uncertainty, global conflict and inflation.

Taxpayers may have difficulty understanding how to approach credits and incentives. The following steps are important for taxpayers grappling with incentive opportunities:

- Review incentive programs already in place to confirm fulfillment of all compliance and performance requirements to mitigate the risk of clawbacks.
- Evaluate current statutory incentives for opportunities to maximize benefits. Some states allow retroactive claims for statutory benefits.
- 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 and potentially other locations that may not have been considered without the possibility of incentives.

Sales and use tax process review

Sales and use tax compliance can be a complex function affecting 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 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 upon current practices, and process-related improvements to help mitigate risk and maximize compliance.

Reverse sales and use tax audits

Businesses in the middle market routinely overpay sales taxes and over-accrue use taxes because those businesses 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 are more likely to have significant refund opportunities due to underutilization of available exemptions, including the manufacturing, construction, large retail, medical care (e.g., hospitals), public utility and agriculture industries.

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.
Much like with traditional digital goods and services, the states continue to lag in providing guidance on state and local taxability of NFTs. 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.

Digital assets can affect state and local taxes. Purchasers and sellers of digital assets, as well as digital asset marketplaces, should evaluate the following:

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

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