State and Local Taxation

Principles and Planning

THIRD EDITION

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CONTENTS

PREFACE

Entrepreneurs, managers, and their tax advisors know what law schools, business schools, and their students are beginning to learn: careers are greatly enhanced by knowing the fundamentals of state and local taxes. This book imparts these fundamentals, which the authors have gleaned from a combined century of experience—as lawyers and accountants, and as professionals and professors—living with (and living off) such knowledge.

The emphasis placed on state and local tax planning by tax advisors can be seen in their staffing. Each of the major accounting firms now has a dedicated state and local tax practice, as do larger law firms. Moreover, many firms have successfully set up boutique practices focused solely on state and local taxation. Successful practitioners know the importance of state and local tax planning in mergers and acquisitions and expansions and relocations. They also know that such planning is even more important in cost-effective downsizing. So do companies: between a third and a half of the time typically invested by tax professionals working in business is devoted to state and local taxes, with the percentage increasing the higher up one goes on the corporate ladder.

There are many good reasons for this focus by businesses and their tax advisors on state and local tax planning. In recent years, more and more transactions and ventures have become subject to different state and local taxes. This is largely because technological advances, most notably the Web, have greatly reduced the costs of operating across borders, even for small companies. Indeed, advances in electronic commerce spawned the rise of a new form of business, the micro-multinational. Today even sole proprietors working out of their garage routinely generate transactions spanning the country: a Web-based retailer can close a sale in their home office in Florida for a supplier in Montana to ship to a customer in New Hampshire. In this way, a retail sale which used to be local can readily involve a multitude of jurisdictions, each eager to tax both the transaction and the parties involved.

Companies can easily become ensnared in the Byzantine web of different taxes imposed by the many governments touched by (or seeking to touch) cross-border transactions. Not only can many different levels of government be involved, but also many different kinds of taxes: some jurisdictions rely more heavily on income taxes; others on sales or property taxes. Adding complexity, even the same kinds of taxes can differ across borders. For example, the definition of taxable income at the federal level usually is different from that used by the many states which impose income taxes. Differences among definitions often are subtle, yet important. Indeed, the various tax rules have only one thing in common: they seldom are easy to understand or permanent because they are created at different times and thus reflect changing government policies.

Stunning advances in telecommunications, capital mobility, and distribution channels not only greatly increased the number of transactions and ventures subject to multiple taxation, but also have made it easier, for those who know what to look for, to plan around such taxes. This is because these environmental changes have reduced the costs of discovering and implementing such plans. The Web has brought greater, quicker, and far less expensive access to the sources of state and local tax rules. An excellent example is http://www.taxadmin.org, the website of an association of state tax agencies named the Federation of [State] Tax Administrators. The wall of tax treatises and loose-leaf services that state and local tax planners previously needed has been replaced by online portals. Furthermore, the same technological advances have made it much easier (and less costly) to negotiate (and relocate people, property, and operations) when shopping among jurisdictions for the most tax-favored locations.

In recent years, state and local taxes also have become increasingly important because they simply are costing more. They are costing more directly: the trend has been for states and local jurisdictions to raise income, sales, and other taxes to avoid budget deficits and expand social programs. State and local taxes also are costing more indirectly. Being for the most part deductible against the regular federal income tax, state and local tax costs has been federally subsidized. However, lower federal income tax rates reduce this subsidy. So has the increase in the number of non-corporate taxpayers forced into paying the federal alternate minimum income tax, for which state and local taxes are not deductible.

Another reason why state and local taxes play an important role in management decisions is that paying taxes typically claims a high priority on a taxpayer's cash flow and capital. That is, not only are state and local taxes often a big expense, but they also must be paid, and must be paid rather quickly. In addition, companies publicly traded in U.S. capital markets can be especially sensitive to state and local taxes. This is because earnings (which usually have a major impact on stock prices) must be reported on an after-tax basis. That is, state and local tax expense reduces earnings per share dollar for dollar. Furthermore, not only must earnings be reduced by taxes expected to be paid in the current year, but reported earnings also must be reduced by taxes expected to be paid in the *future*. Because senior managers' compensation usually is tied to earnings *via* stock prices (*e.g.*, through stock options), key business and investment decision makers often have a high personal stake in reducing state and local taxes.

In sum, to maintain a competitive edge, entrepreneurs and managers must have a fundamental understanding of the state and local tax implications of key transactions. Those who are able to identify state and local tax issues can also make more effective use of tax consultants because challenges and opportunities can be spotted as they arise before basic negotiations are concluded and the outline of the deal solidified.

Knowledge of state and local taxation is even more crucial for professionals who advise organizations, particularly for accountants and lawyers. By understanding the role of state and local taxes in a strategic setting, consultants—especially "number crunchers"—can greatly increase value for a business.

All in all, there are many factors which combine to motivate efforts to optimize state and local taxes. Those who want to do so, and students who aspire to be someone who does, should buy this book.

ACKNOWLEDGMENTS

Being able to function in a field of such complexity was not won easily, and likely would not have happened without the help and guidance of people and institutions too numerous to list here. However, some should be named—first and foremost being our families, who inspire us constantly. Also high on the list are Steve Buda and the other fine people of J. Ross Publishing who inspired us on this venture. Finally, we thank Doug Hill for his excellent editing.

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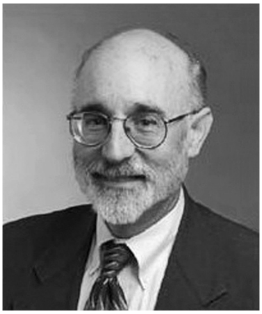

John E. Karayan, JD, PhD, is a Senior Lecturer in Accounting at the University of Southern California's Marshall School of Business and a Professor of Accounting Emeritus at the California State Polytechnic University, Pomona. He is a tax attorney with a Big 4 CPA firm background who left professional practice to become a full-time university professor. Formerly Director of Taxes of one of the world's largest software companies—a NYSE-listed group that operated in all 50 states and over 100 countries—Professor Karayan has remained active outside of academia as an expert witness on accounting issues in complex business litigation. He also served for years on the Board of Directors of the world's foremost manufacturer of anti-terrorist vehicle access barricades. Dr. Karayan's books include

Strategic Business Tax Planning (2007) with Charles Swenson. John also has published articles in journals ranging from *The Tax Advisor* to the *Marquette Sports Law Review*, and has spoken before professional groups such as the World Trade Institute, California Continuing Education of the Bar, the European Accounting Association, and the California Society of CPA's. Building on his background in high-tech business, he served as President of the American Accounting Association's *34th Annual Western Regional Conference* on Electronic Commerce—the first of its kind.

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Joseph W. Neff, JD, needs no introduction to the state and local tax community. His previous experience includes being a partner in the Los Angeles office of PricewaterhouseCoopers, where he was national director of the middle market tax practice. He was also managing director of the state and local taxation (SALT) practice (as well as a partner) at RSM McGladrey. He has vast experience and a high level of expertise in SALT.

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Downloads for *State and Local Taxation, 3rd Edition*, include instructor material for adopting professors.

PART I

A Framework for Understanding State and Local Taxation

CHAPTER 1

THE IMPORTANCE OF STATE AND LOCAL TAX PLANNING

INTRODUCTION

State and local tax planning has increased in importance in recent years. One reason is that federal tax planning opportunities have declined. Another is that more taxes have been levied at the state and local level. (For specifics, visit the websites for state and local tax agencies.) Overall effective business tax rates, which will be discussed later, are approximately 20%, which is almost as high as the U.S. corporate income rate of 21%. A map-based set of links, as well as a wealth of other information, can be found on the website of the Federation of Tax Administrators (FTA), currently at http://www.taxadmin.org/fta/link/default.php. This group is composed of the senior tax administrators of each state.

For many companies, state and local tax planning consumes a considerable amount of their in-house tax staff time, and such taxes account for a significant amount of their tax burdens. For example, in a survey by one of the Big 4 accounting firms, state and local tax planning was found to consume 48% of the surveyed companies' overall in-house tax staff time, and accounted for 46% of the companies' overall tax burdens. Another indication is that each of the Big 4 accounting firms, along with most large CPA and law firms, maintain a dedicated state and local tax group with the express goal of advising entrepreneurs and managers on how to address state and local tax challenges (as well as taking advantage of opportunities for state and local tax benefits) to enhance the bottom line and cash flow.

The force that is driving the need to understand (and use) state and local tax knowledge is largely a function of the dynamism—some would say chaos—that is, in turn, driving state and local public finances in the information age. Simply put, technological advances have made it much easier to sell goods and services from remote locations. Traditionally, businesses without property or employees that are physically present in a jurisdiction cannot be taxed by it. This has meant a possible erosion of state and local bases when brick-and-mortar stores are replaced by e-tailers. At the same time, state and local politicians have clamored for greater tax revenues to finance increased spending for pensions and payroll, not to mention education, safety, and health care. The importance of state and local taxes also is a result of massive changes in federal tax laws during the past three decades.

There are several reasons for this. Although state and local income tax laws now conform to the federal laws more than ever, stubborn nonconformity coupled with significant increases in state and local tax rates have greatly increased the relative burden of state and local taxes. Furthermore, quite a bit of the state legislation that is conforming to the federal approach has taken affect after a time lag (even as many states automatically linked their tax law to that of the federal government). In addition, there is the impact of a broader reach for the individual alternate minimum tax (AMT). State and local taxes are nondeductible for the individual AMT. This increases their after-tax cost, which has raised the cost of doing business, particularly for owners of businesses operating as flow-through entities such as Subchapter S corporations, limited liability companies, or partnerships.

The years of federal tax reform that focused on widening the tax base—for example, 1981 through 1991—created a windfall of state and local income taxes. The reverse occurred when the pendulum swung the other way over the next quarter century. Although headline individual tax rates increased, the federal tax base was eroded for some taxpayers with new deductions. More important, multinational firms, spurred by the U.S. having one of the highest business income tax rates in the developed world until 2018, have been motivated to employ transfer pricing tools to significantly move taxable income outside the U.S. For many jurisdictions, these changes also eroded the state and local income tax base. (Masked by enhanced revenues from employee stock options and stock market profit taking in boom years, the ensuing return to normal patterns has revealed shortfalls in state and local taxable income that had been building.)

Because there have been time lags, as well as specific efforts to reject federal law changes, there often have been basic differences for assets. That is, the remaining cost for federal purposes often has been different from that used by other jurisdictions. This is particularly evident for long-lived assets, such as qualified retirement plans and depreciable assets. More important, even after years of steady efforts to conform state income tax laws to the federal laws, there remains a basic difference—the *unitary tax* concept—complementing the multitude of other federal-state differences. This concept is employed by unitary states—basically those west of the Mississippi—for two purposes. The first is to combine commonly controlled but separate legal entities, such as a group of corporations or a corporation and a partnership where all of the entities are part of one economic unit. This is much like the consolidation rules for financial accounting found in U.S. generally accepted accounting principles.

Although consolidated returns can be elected for federal purposes, most foreign corporations cannot be included in one. To the contrary, unitary states usually require that foreign subsidiaries be included in the combined state income tax. In some cases, states can require that foreign parent corporations be included, as well as their other subsidiaries even if they are not incorporated or do not operate in the United States. Other states do not require that foreign subsidiaries be included, stopping the reach of unitary taxation at the *waters' edge*.

The second aspect of the unitary approach is to allocate and apportion income that is earned by a taxpayer who is operating a multistate business. The purpose is to let states tax a *suitable* portion of a firm's business income if those states are being touched by that firm. (A firm's nonbusiness income, such as interest income from investments of working capital, is not apportioned among the states. Instead, all of it is allocated to the jurisdiction where the firm is headquartered. This provides a state and local tax incentive for corporate *inversions*.)

Unlike the federal *arm's length* rule—which is the international standard, by the way—the unitary approach does not look at the fairness of transactions between related companies. Instead, it seeks to rationally apportion to a state all of a company's business income that was generated by contacts with the state. This is done by applying an averaging formula that is typically composed of a combination of the firm's relative property, payroll, and sales in a particular state. To do this, most states have adopted—albeit often only in part—the model proposed by the *Multistate Tax Compact*. This is an association that is sponsored by various states. Under the Compact, a model statute was developed: the *Uniform Division of Income for Tax Purposes Act* (UDITPA).

Notwithstanding this move to create some conformity among states, the unitary approach can lead to the specter of states as a whole—taxing more than 100% of a firm's income. For example, factors of production other than property, payroll, and sales are ignored. More important, different formulas are applied by different jurisdictions. A prime example is that some states apportion based on sales alone. In addition, states differ on how to quantify a firm's factors in general. They also differ on where to *source* factors; for example, in which state does a web-based sale occur? Is it the state from which the firm ships or the state where the customer is located? Another reason that state and local taxes are important is that substantial penalties can apply even to honest mistakes if they are negligent because sufficient research was not done. Taxpayers have an affirmative duty to know the state and local tax law of the jurisdictions in which they generate revenue. Breach of this duty due to ignorance of the law is punishable by monetary penalties (not to mention attorney and accountant fees).

Finally, intense legislative pressures on state and local tax authorities to raise revenues have motivated creativity in *enforcing* the law. This approach is quite risk free for state and local tax agencies because in order to effectively challenge creative tax enforcement, taxpayers almost always must pay the tax assessed and then only find recourse in a lawsuit for a refund in an expensive and lengthy court action. This is not the case with federal tax rules, which may be challenged in U.S. Tax Court before taxes are paid.

VARIOUS TYPES OF TAXES LEVIED ON BUSINESSES

Each of the states, and most of their political subdivisions, impose a variety of taxes. Table 1.1 identifies several common state and local taxes levied on businesses, the number of states imposing each tax, and the relative burden of each tax. In order to accomplish this, sales and use taxes are not included in Table 1.1. Although these are major sources of revenue, they have been excluded because public records do not distinguish between the amount of sales and use taxes paid by businesses and the amount paid by individuals. Note that because

Table 1.1 Taxes levied upon businesses

Type of Tax	No. of States	% of Total Taxes
Property Tax—Real Estate	49	41.58%
Property Tax—Personal	41	11.07%
Property Tax—Other	41	6.02%
Alcoholic Beverage License	47	0.25%
Amusement License	34	0.19%
Corporation License	48	3.05%
Motor Vehicle License	49	7.44%
Public Utility License	31	.030%
Corporation Net Income Tax	45	19.71%
Severance Tax	33	4.00%
Document and Stock Transfer	30	1.89%
Taxes on Non-Employee Compensation	15	0.16%
Unemployment Insurance	49	4.33%
Total		100.00%

purchases for resale are almost always exempt from such taxes, the vast majority of sales and use taxes are paid by individuals.

For historical reasons, the numbers presented are from 2001 because the relative amounts have not changed substantially since then. Current data can be seen in the annual reports of the U. S. Census Bureau on the relative burden of state and local taxes. Summaries of these reports are posted every year on the website maintained by the FTA, which is currently located at http://www.taxadmin.org/fta/rate/burden.html.

VARIOUS BUSINESS TRANSACTIONS SUBJECT TO TAXATION

Each state along with many of the counties, cities, parishes, school districts, and other governmental subdivisions impose taxes in a variety of transactions. Figure 1.1 shows businesses, parties that are essential to business operations, and (in parentheses) various transactions that are subject to taxation. Again, the amounts shown are for 2001, but, as noted previously, the relative amounts have not changed much since then. Current numbers are posted every year on the website maintained by the FTA, as was mentioned earlier.

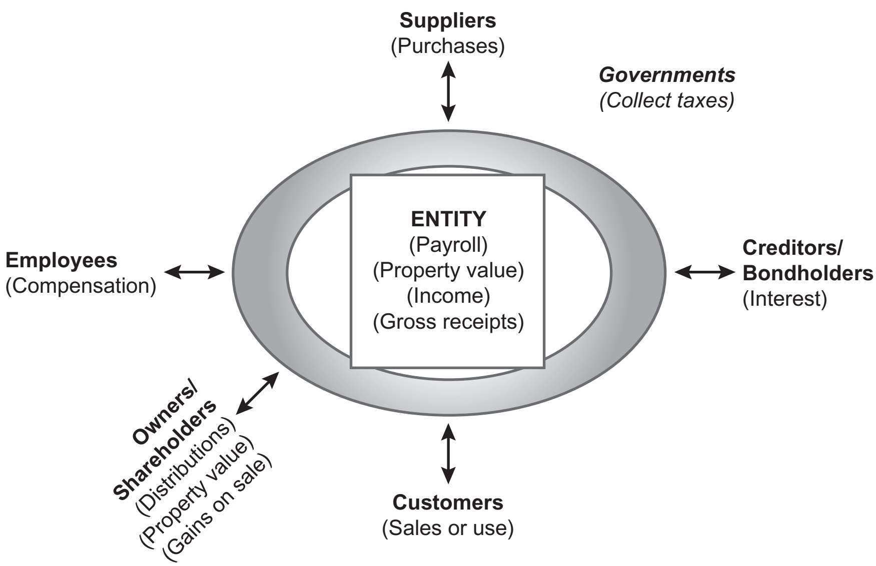

Figure 1.1 Various business transactions subject to taxation

DISPARITY OF TAX RATES ACROSS JURISDICTIONS

Tax rates vary dramatically across state and local taxing units. Table 1.2 lists the effective income tax rates on business income for each state. Rates are calculated by dividing all taxes paid by businesses by gross state product attributable to businesses. As in the previous example, the figures again are for the base year

Table 1.2 Effective business income tax rates by state*

State	Effective Tax Rates on Business Income	Ranking	State	Effective Tax rates on Business Income	Ranking
Alabama	12.45%	40	Nebraska	6.63%	48
Arizona	25.70%	7	Nevada	10.69%	43
Arkansas	9.96%	45	New Hampshire	25.82%	6
California	15.97%	30	New Jersey	23.24%	8
Colorado	14.47%	34	New Mexico	16.86%	24
Connecticut	21.26%	11	New York	26.84%	5
Delaware	32.92%	3	North Carolina	12.01%	41
DC & Maryland	14.44%	36	North Dakota	11.14%	42
Florida	20.92%	13	Ohio	15.60%	31
Georgia	13.98%	37	Oklahoma	16.62%	26
Hawaii	7.84%	46	Oregon	16.28%	28
Idaho	7.22%	47	Pennsylvania	17.03%	23
Illinois	21.19%	12	Rhode Island	18.47%	19
Indiana	18.76%	18	South Carolina	19.72%	15
Iowa	10.24%	44	South Dakota	4.22%	49
Kansas	14.71%	32	Tennessee	14.62%	33
Kentucky	21.30%	10	Texas	17.65%	21
Louisiana	21.46%	9	Utah	12.63%	39
Maine	19.30%	16	Vermont	16.61%	27
Massachusetts	16.26%	29	Virginia	13.91%	38
Michigan	39.74%	2	Washington	19.83%	14
Minnesota	17.74%	20	West Virginia	26.89%	4
Mississippi	16.82%	25	Wisconsin	17.50%	22
Missouri	14.47%	35	Wyoming	42.63%	1
Montana	19.09%	17			

*Alaska was omitted due to insufficient data

2001 since the relative amounts have not changed much (current data are posted by the FTA). Note that two states have effective income tax rates higher than the *highest* federal corporate income tax rate of 35%. Wyoming's high effective rate is driven by large severance tax collections. At an aggregate U.S. level, overall effective rates from 1997–2017 averaged 19.8%, which is almost as high as the current U.S. corporate income tax rate of 21%.

TAX LIABILITIES ARISING IN MULTIPLE JURISDICTIONS

Traditionally, the U.S. Supreme Court has interpreted the Constitution as limiting states to only tax transactions occurring within their borders. However, because business transactions have at least one buyer and one seller, more than one state may tax the same cross-border transaction. Even within a state, many political subdivisions—notably counties, cities, and school districts—may get into the act. As highlighted in the preface to this book, such cross-border sales have increased due to technological advances, such as the web, as well as other changes in the economy that have lowered the risk and cost of expanding markets. Mergers and acquisitions involving entities in multiple states have increased as well.

While advances in telecommunications, distribution channels, and management information systems have dramatically reduced internal barriers within the economy, they also have increasingly exposed the parties to these transactions to the multiple tax jurisdictions. More and more, state and local governments have joined the federal government as, in effect, a third party to these transactions, even if the business being taxed does not operate out of brick-and-mortar establishments located in these jurisdictions. Today's entrepreneurs and managers thus must be well versed in the basics of state and local tax planning to effectively and efficiently deal with the additional tax-related costs arising from cross-border transactions so that the benefits and burdens arising from such transactions are optimized. More important, entrepreneurs and managers are looking to their accountants, attorneys, and other outside consultants for help and insight in this area, and are willing to pay well for good advice.

Deciding where, when, with whom, and how transactions are structured can significantly impact the state and local tax burden of businesses when you consider the variety of taxes, the number of transactions that are subject to taxation, the disparity of tax rates among jurisdictions, and the possibility of owing taxes in multiple states. In other words, state and local tax planning really does merit the consumption of half of the in-house tax staff's time.

The remainder of this chapter introduces the various types of state and local taxes, the key sources of law that are controlling state and local taxation, and fundamental planning strategies.

TYPES OF TAXES

Corporate Income and Franchise Taxes

Most states, but not all, tax corporate net income. For reasons discussed later in this book, some states refer to this tax as a franchise tax; however, most states call it a corporate income tax—currently, 45 do. (This includes the District of Columbia, which, for convenience, is usually included throughout this book when referring to states.) A list of these states, as well as their tax rates, typically is published every year on the website of the Tax Foundation at http://taxfoundation.org/ (the Tax Foundation is a tax policy research organization). Of the states *not* included in the list of 45, Nevada, Ohio, Texas, and Washington impose *gross* receipts taxes on businesses, rather than taxes based on net income. More precisely, Ohio imposes a commercial activity tax on gross receipts, Texas assesses a gross margin tax, and Washington levies a business and occupations tax that is based on gross receipts. Nevada imposes a commerce tax on revenues greater than $4 million per year.

South Dakota and Wyoming have neither. Delaware and Virginia currently impose a gross receipts tax as well as a net income tax. Top rates currently range from a low of 4.5% in North Dakota to a high of 12% in Iowa, but traditionally raise relatively little state revenue (currently about 5% of state tax collections and 2% of all state revenues). To calculate net income taxes, most jurisdictions *piggyback* on taxpayers' compliance with the federal tax law. Interestingly, the Internal Revenue Code (IRC) specifically allows any state to let the Internal Revenue Service (IRS) administer and collect the state's income tax. Although this has long been the law, no state has ever accepted the offer.

Piggybacking on federal income is done in three steps. First, the taxpayer starts with federal net income. (Many states require that the federal income tax return, or key portions of it, be attached to the state return.) Second, the taxpayer makes some state-specific adjustments. Finally, the state tax rate and any state tax credits are applied. State rates are lower than the federal rate with the federal rate (after 2017) being 21% and state rates ranging from about 4 to 12%.

As could be anticipated, jurisdictions that piggyback on federal income typically apply federal statutes, federal rules and regulations, and federal case law when dealing with controversies. The usual exception is when the state has its own specific statutes where the language is significantly different from that of the IRC. Another exception is where the state has its own regulations or case law that significantly differ from the federal regulations. Similarly, to a great extent, federal elections also apply to piggybacking states. This usually applies not only to elections of accounting methods and periods but also to extensions of due dates and other procedural matters where there is no specific state rule.

However, strict conformity is not required. A taxpayer often may take some action for federal purposes and not for state purposes, or *vice versa*, as long as federal-state conformity is not mandated by state law. In addition, significant differences between federal and state tax rules exist even for piggybacking states. One major set of differences comes from special economic incentives. These usually are targeted for economically depressed areas or for industries that a state is trying to subsidize. These types of incentives are specified by state or local statute, and often provide a panoply of benefits to investments generating employment in these areas. These range from reduced sales taxes for plant, property, and equipment to investment tax credits and accelerated depreciation on the same.

Sometimes there are employment tax credits that greatly reduce the after-tax cost, even of new minimum wage employees, or special treatment for start-up costs or losses. More (and more favorable) benefits are usually specified for special enterprise zones. Often modeled after federal law, these programs usually provide special and higher levels of tax incentives and other benefits (such as sweetheart access to local utilities or other governmental services) for businesses established in designated depressed areas. Other incentives are provided for favored industries, such as sports franchises, film and television production, and alternate energy sources.

As suggested before, high among the key issues for state and local taxes are (1) determining when a business is subject to a state's taxing jurisdiction and (2) deciding how to split the income of a multistate operation among the various states involved. As to the former, the U.S. Supreme Court traditionally has ruled that states cannot impose a tax on a purely out-of-state business, but in the past decade has greatly limited the definition of *purely out-of-state*. Indeed, it may even overrule previous decisions requiring some physical presence, as suggested in Justice Kennedy's concurrence in *Direct Marketing Assn. v. Brohl* 135 U. S. 1134 (2015).

In addition, states are increasingly enacting *factor nexus* or *economic nexus* statutes, whereby firms with no property or employees in a jurisdiction are subject to tax solely because of a threshold level of sales to customers located there. This trend has been hastened in the sales tax area after the Supreme Court decision in *Wayfair v South Dakota*.

If an out-of-state business meets a jurisdiction's minimum threshold, then it is faced with determining how much of its income is taxable there. As noted before, many states use an averaging mechanism. Typically, a variant of the three-factor Massachusetts formula is used. This averages the ratios of property, payroll, and sales within and without the state, and is used to apportion business income into the state. This roughly divides up income to where it is earned, but because it is only an approximation, it causes a great deal of controversy. The silver lining in this cloud is that the method also allows for tax planning in order to source more income to lower tax jurisdictions. Increasingly, a number of states have placed 100% of the weight on the sales factor.

State and local tax procedures and appeals are similar to, but different from, federal methods. They vary quite a bit by state, but one commonality is that after administrative appeals are made, taxpayers must pay the additional taxes that were demanded and then sue for a refund in a regular state court (unlike the federal approach, which allows an appeal to the U.S. Tax Court without first requiring that the tax assessment be paid).

State and local tax audits are run very much like those by the IRS, except that there is often an extended statute of limitations—even for honest, timely filing taxpayers. Rather than the federal standard three-year statute of limitations, four years is often used—giving state tax auditors a year to follow up on the reports they receive about IRS action for taxpayers giving permanent addresses in the state. In a similar vein, a state amended return often must be filed within a short time (usually 90 days) of the filing of a federal amended income tax return and also within a similar period from a final determination of changes, such as from a federal audit.

Income Taxes on Other Entities

Income taxes on other entities tend to follow the federal lead. For example: mutual funds, publicly traded partnerships, cooperatives, real estate investment trusts, and tax-exempt entities are generally treated the same for federal income taxes as for state and local income taxes. Nevertheless, there is a wide variety of federal-state differences. Some of these differences are fairly obscure. Whereas the federal treatment of homeowners' associations is much like that of any other tax-exempt organizations, some states (such as California) initially classify these as taxable, albeit with special deductions that render all but the most solvent homeowners' associations *tax free*. The differences that are not obscure are largely in the area of flow-through entities, such as partnerships, S corporations, and limited liability companies.

Taxation of Flow-Through Entities

Firms often use flow-through entities. Examples include joint ventures with other firms, or a new business in a state where the flow through of tax losses to a financing partner is advantageous. State and local tax treatment of three flow-through entities—partnerships, limited liability companies, and S corporations—is much the same as federal taxation. However, there are some important differences.

Partnerships

A partnership is an association of two or more persons carrying on a business for a profit. For federal tax purposes, partnerships have two major advantages: partnerships are not subject to tax and their losses pass through to their partners.

Limited liability companies are generally treated like corporations, but are taxed as if they were partnerships. This marries the limited liability for passive owners provided by the corporate form with the single tax provided by a partnership. Similarly, a special type of partnership that is allowed in most states, is a limited liability partnership (LLP). With an LLP, if the action of one or more partners causes liability, personal liability (i.e., extending to the partner's individual assets) is limited to the partner(s) causing the action.

Most states do not tax partnerships. Instead, partners are taxed on the distributive shares of profit or loss that are passed through. Exceptions are the District of Columbia (unincorporated business tax), Illinois (personal property replacement tax), New Hampshire (business profits tax), and New York City (unincorporated business tax). Some states (e.g., California) impose a withholding tax on allocations to nonresident taxpayers, and allow the partnership an election to effectively pay state income taxes on behalf of such partners (so-called *composite returns*). A similar pattern applies to Subchapter S corporations.

Generally, a partner is subject to state and local taxation if the partner is either a resident of the jurisdiction of the partnership or is a nonresident but is doing business there. Individual partners are also subject to taxation by their state of residence on their entire taxable income, including their distributive share of partnership income. However, most jurisdictions provide a resident individual with a credit for taxes paid to nonresident states. Like the federal foreign tax credit, it is usually limited to the lesser of the amount of tax computed by multiplying the taxpayer's total tax by a fraction or the amount of tax actually paid. The fraction is the amount of taxable income subject to tax in the nonresident jurisdiction under the resident's state tax laws over the resident's entire taxable income. However, most states do not provide a credit either for a tax paid by the partnership directly or for taxes paid by the partnership on behalf of its nonresident partners.

Income Taxes on Employees and Sole Proprietorships

States that impose corporate net income taxes typically tax the net income earned by individuals—at last count, 44 states do. However, unlike corporate income taxes, individual income taxes are a major source of revenue—typically about 35% of state tax collections. Forty-two states tax wages. New Hampshire and Tennessee only tax certain investment income. Currently, Alaska, Florida, Nevada, South Dakota, and Wyoming levy no personal net income tax. Washington also has no personal income taxes, but imposes a gross receipts tax on individuals who are engaged in a business; the rates vary by the type of business.

Some states have a flat tax; most have progressive tax brackets. Top rates currently vary from about 3% in Pennsylvania to over 13% in California. In limited circumstances, Hawaii accepts .5% of gross sales. A list of states, as well as their tax rates, is typically published every year on the website of the Tax Foundation.

Although few local jurisdictions impose an income tax, nearly 5,000 located in about a third of the states, do. The rates tend to be small: typically 1–2%, but nearly 4% in New York City. Periodically, a list of both jurisdictions and their rates are posted on the Tax Foundation's website.

A similar approach (and similar issues) is involved in state and local income taxes on employees and sole proprietorships. Typically, the calculation of the tax base also starts with federal taxable (or adjusted gross) income. Then federal-state differences are listed regarding state and local taxable income. Last, the state and local tax rates and credits are applied. It is not unusual to find a state alternate minimum tax modeled on the federal method.

As with corporations, key issues include who is subject to a state's power to tax (e.g., nexus) and how the income of a multistate operation is parceled out between the states involved (e.g., formula apportionment). These are treated much as previously discussed. Additionally, in most states there are two major divisions of personal income taxes that affect employees and sole proprietorships. The first division is for residents and the second is for nonresidents and part-year residents. The distinction is made because in many states residents are taxed on their worldwide income, whereas nonresidents are only taxed on their income from sources within the state.

Income is generally sourced where it is earned. For example, it is usual for rents to be sourced (and thus taxed) by the jurisdiction where the property is physically located. Similarly, royalties are sourced where the underlying intangible is being used. Services typically are sourced to where they are rendered. Sourcing may be simple for income from real estate (because it does not move around much), but can become devilish for multistate business operations where the various steps in a firm's value chain are located in different jurisdictions. As noted before, the resulting income is often merely divided among the jurisdictions involved by using some averaging convention.

A nonresident is usually defined, if at all, as an individual who is not a resident. A person typically is a resident if physically present in the state for other than a temporary or transitory purpose. (Case law dealing with the question of residency is discussed later in this book. The law is embedded in cases because issues are so fact-ridden and many groups of individuals are similarly situated.) As a rule of thumb, a person who moves to a state to take a job, start a business, retire, or who is physically present in the state for a substantial period (e.g., more than nine months during a tax year) becomes a resident upon entering the state.

Sales and Use Taxes

Currently, there is a sales tax in all but four states: Delaware, Montana, New Hampshire, and Oregon. There is not a statewide tax in Alaska, but there are local sales taxes. These taxes are typically based on gross receipts from the retail sale of tangible purchases of personal property intended for in-state use. Services are sometimes included in the tax base. In addition to statewide tax rates, local taxes are often added on. This can result in a variety of total sales and use tax rates within the same state. The combined rates vary from under 2% in Alaska to more than 9% in Arkansas and Tennessee. A list of states, as well as their tax rates, is typically published every year on the website of the Tax Foundation.

Sales taxes apply to in-state retail purchases. They usually are complemented by use taxes, which apply to out-of-state retail purchases for in-state use. The use tax discourages a state's residents from making purchases in another state in order to avoid the sales tax. The success of this approach has been increasingly challenged by the rise of e-tailers. This is because an out-of-state firm may not have a legally enforceable obligation to collect and remit the use tax. As discussed extensively throughout this book, the existence of a legal obligation depends on the extent of the vendor's contact with the consumer's state. In response, many states have enacted *click-through* nexus laws to force out-of-state remote sellers to collect taxes. Moreover, 35 of the 45 states have adopted economic nexus laws that require collection if an out-of-state vendor exceeds a threshold sales number per year.

Many purchases, however, are exempt from sales and use taxes. Purchases of necessities, such as groceries and medicine, are commonly exempt. Property used in the production of inventory, purchases for resale (as well as packaging), ingredients in the final product, and equipment (or parts thereof) used to make products also are not taxed. This prevents double taxation when the product is resold to consumers.

Property Taxes

Taxes are usually assessed on both realty and personalty. In some states, only realty is taxed. A variety of statistics can be found on the Tax Foundation website and a map-based table of tax rates is currently posted at http://www.tax-rates.org. Taxes are usually based on the value of the property at a specific assessment date or point in time. Property owners are liable for payment of the tax. Valuation methods, tax rates, and assessment dates vary by state. Business inventories are sometimes exempted from tax and some jurisdictions impose taxes on intangibles.

In response to a variety of lawsuits regarding large differences in the amount of per pupil funding where property taxes finance schools, there has been a shift to financing schools using state-level funds. This may have broken the traditional link between property taxes and local spending. In any event, several jurisdictions (notably California, Massachusetts, and Michigan) have changed their property tax system to limit increased tax rates and valuations.

Other Taxes

While the majority of state tax collections are from income, sales and use, and property taxes, other taxes significantly affect businesses and transactions. The vast bulk of the other taxes raised are payroll and excise taxes. These include utility taxes, such as those on cable TV or electricity, as well as *sin* taxes on tobacco products and alcoholic beverages and *bed* taxes on hotel rooms.

Entertainment taxes could be the next area for battles over nexus. Although traditionally imposed on face-to-face entertainment such as in movie theaters or amusement parks, in mid-2015, the City of Chicago's Department of Finance ruled that the 9% Chicago amusement tax has always applied to amusements that were delivered electronically. However, it was also announced that it would limit the effect of this ruling after August 31, 2015, and that it applies to streaming or other temporary downloads of shows, games, or music over the web rather than permanent purchases.

State payroll taxes have become increasingly important. Along with withholding where there is a state personal income tax, states impose unemployment insurance taxes. Like federal Social Security taxes, these may include both an employer tax and an employee tax. The most common example of the latter is taxes for state disability benefits levied on employees that must be withheld from employees' wages. Other taxes include insurance company taxes (which typically are on gross receipts, rather than on income), motor vehicle registration taxes (along with those for boats and planes), state business and occupations taxes, realty transfer taxes, and hazardous waste taxes. There also are local business and occupation fees—some are inconsequential, some are large, some are flat rate, and some are measured by gross receipts or payroll.

Capital Stock Taxes

Capital stock taxes usually are levied on domestic (in-state) corporations for the right to exist as a corporation. They also apply to foreign (out-of-state) corporations for the right to do business in the state. States often base capital stock taxes on a corporation's net book value, which includes capital, surplus, and retained earnings.

License Taxes

License taxes are imposed for the right to conduct certain businesses or professions. These taxes are intended not only to raise revenue but also to regulate certain businesses and professions. State and local governments both impose these taxes.

Estate, Gift, and Inheritance Taxes

Currently, 13 states and the District of Columbia have an estate tax, but this number can change often. Mostly, these states are located in the Northeast, the Northwest, and the upper Midwest. Again, the Tax Foundation website is a good source for comparative data.

These taxes are generally modeled after the federal system. Except for the *pick-up* tax, where the state gets the maximum amount that can be taken as a state death tax credit against the federal estate tax liability—these taxes usually cost more to collect than they bring in. Instead of estate taxes, which tax the property left by a decedent, some states impose an inheritance tax, which imposes a tax on those who inherit the property. Six states have an inheritance tax. Collection issues aside, it is much the same thing as an estate tax. (Maryland and New Jersey have an estate tax and an inheritance tax.)

Taken together, these basically are a tax on the privilege of giving property away. The gift tax applies to transfers of property interests made during the owner's lifetime, provided the giver (called a donor) does not get something of legal value in exchange. An estate or inheritance fundamentally results from the decedent's last gift. Some states have a lower rate for gift taxes; rates and exemptions for inheritance taxes are usually based on the level of kinship with the decedent (for example, a surviving sister is charged much less than a first cousin, twice removed).

Transfers to a spouse, a charity, and political parties usually are not taxed, and there are exemptions and credits that reduce taxes for *small* amounts. These taxes are more of an administrative nuisance than a revenue raiser.

Transfer Taxes

States impose transfer taxes on changes of property ownership. (A form of this, the British *Stamp Tax* on certain documents, was the target of the Boston tea party.) The tax is usually imposed on the transferor. For example, some states impose a transfer tax on the transfer or sale of stock or securities, typically exempting initial public offerings from the tax. Other states impose a tax on the transfer or sale of realty at the time of recording or transfer.

Incorporation Taxes

States levy incorporation taxes on the incorporation of domestic corporations, and similar taxes on the qualification to conduct business in the state by foreign corporations. The tax is based on the value of a corporation's stock or is merely a flat fee.

Excise Taxes

As previously noted, a wide variety of jurisdictions impose taxes on the consumption of regulated goods and services. These range from gasoline to air travel, from cigarettes to hotel rooms, from cable TV to parking, and from electricity to entertainment.

Severance Taxes

States assess severance taxes on the removal of natural resources, such as timber, minerals, and petroleum. The tax is based on the value of the extracted resources. In some states, these taxes are quite substantial. Texas traditionally has financed its schools on taxes like these, as well as royalties; Alaska effectively has a negative income tax on its residents, which in the past largely has paid out *dividends* from severance taxes and royalties.

Additional Miscellaneous Taxes

States also levy an array of other taxes. Most notable are motor fuel taxes, telecommunications taxes, tourism taxes, value-added taxes, commercial rent taxes, and highway use taxes.

SOURCES OF LAW

This section identifies important sources of law that authorize, set forth, and limit state and local taxes. The sources of state tax laws are similar to the sources of federal tax laws. States have legislative bodies that enact tax laws, agencies that administer the laws, and courts that hear disputes between taxpayers and tax authorities. States also have quasi-judicial tribunals to hear tax disputes in order to expedite the resolution of disputes and to ease the burden on the courts.

The U.S. Constitution

The U.S. Constitution is the highest authority on state tax law. Any state law that violates the Constitution is *unconstitutional* and thus invalid. As previously noted, the U.S. Supreme Court has traditionally ruled that the Constitution generally limits the scope of state and local taxation to property, people, and transactions located within the jurisdiction.

The Constitution generally performs three functions. First, the Constitution enumerates specific rights of persons in relation to the government. State tax laws infringing on these rights are invalid. For example, states can only levy corporate income/franchise taxes on corporations having *nexus* (a certain level of business contact) to the taxing state. State tax law attempting to impose such taxes on a business without *nexus* is invalid.

Second, the Constitution divides governmental power between federal and state governments. This division of power does not necessarily result in two separate arenas or jurisdictions of government action. Sometimes federal and state governments exercise overlapping jurisdiction regarding public concerns. The Supremacy Clause of the Constitution provides that federal law controls and that state law is invalid when a conflict arises between federal and state law.

Third, the Constitution divides federal governmental power among legislative, executive, and judicial branches. These branches are responsible for enacting, enforcing, and interpreting federal laws.

State Constitutions

State constitutions perform two functions. First, state constitutions establish the supreme law of the state by enumerating specific individual rights. As with California's constitutional amendment known as Proposition 13, sometimes these limit the ability to tax. However, state constitutions cannot be in violation of the U.S. Constitution. Second, state constitutions divide power among legislative, executive, and judicial branches. These branches are responsible for enacting, enforcing, and interpreting state tax laws.

Legislative Law Sources

State legislatures enact statutes, that is, the laws of the state. All state legislatures consist of two houses, except Nebraska, which has only one house. The houses perform slightly different but overlapping lawmaking functions. Statutes are enacted after receiving the approval of both legislative houses and the governor.

Local laws are enacted according to local government procedure. Subject to constitutional limitations, statutes are the highest authority of state and local tax law.

Administrative Law Sources

State governments create agencies to administer the law. Most agencies are created by statute, but some are created by constitutional provision. Agency heads are either elected or appointed by the governor and approved by the legislature.

In most states, a single revenue agency administers state tax laws. However, counties and cities typically assess and collect property taxes. In addition, specialized agencies often collect capital stock taxes, employment taxes, and public utility taxes. For example, California divides tax administration between two revenue agencies. The unelected Franchise Tax Board administers income taxes, and the elected State Board of Equalization administers sales and use taxes, as well as hearing appeals from income tax audits.

Revenue agencies issue various authoritative pronouncements. First, agencies regularly issue rules and regulations. They are only the issuing agency's official interpretations of state tax laws. Occasionally, legislatures permit a rule or regulation to operate with the force of law, like a statute.

Second, agencies often follow the IRS model of drafting letter rulings in response to taxpayer requests for guidance. These letters are taxpayer specific and thus do not have a broader application. They cannot be relied on as an authority by other taxpayers. However, they may be useful in ascertaining an agency's position.

Third, agencies publish hearing decisions that are the results of quasi-judicial and administrative tribunals that hear taxpayer disputes. Like letter rulings, hearing decisions cannot be relied on as law, but they illuminate agency positions on certain issues. Agencies routinely publish departmental announcements, including news releases, newsletters, and tax advisories that identify agency positions. They are not sources of law and are generally not binding on the agency.

Judicial Law Sources

Judges publish legal opinions to resolve litigation and thereby create case law. Case law consists of the interpretation and application of the various sources of law: constitutional, statutory, administrative, and common. Judicial decisions only bind states and localities over which the court has jurisdiction. For example, the Idaho Supreme Court's interpretation of a U.S. constitutional provision is binding within the state of Idaho, but is not binding in the state of Nevada.

All states maintain two or three levels of courts. Each level performs a specific function. The lowest level is the trial court. A trial court determines the facts of a dispute and then applies the relevant law to the facts. The next level is the intermediate appellate court. This appellate court reviews the trial court judge's use and application of the relevant law to the determined facts. These courts rarely reevaluate or redetermine the facts found at the trial level. Some states do not have intermediate appellate courts.

At the highest level, the final appellate court reviews the decisions of the intermediate appellate court. If no intermediate appellate courts exist, the final appellate court directly reviews the decisions of the trial court. The final appellate court exercises jurisdiction over the entire state. Further review on questions of federal law may be sought in the U.S. Supreme Court, which decides just a handful of such cases annually.

Multistate Law Sources

In 1967, the Multistate Tax Commission was created when a group of states endorsed the drafting and adoption into law (in whole or in part) of the Multistate Tax Compact. The Multistate Tax Compact is an interstate compact law enacted by Compact Member States. Over half of the states are full or associate members of the Commission.

The Commission encourages states to adopt uniform tax laws and regulations that apply to multistate and multinational enterprises. The goals of uniformity in multistate transactions are:

- Reduce compliance burdens for multistate businesses
- Prevent under-taxation or over-taxation of interstate commerce
- Lessen the possibility that Congress will intervene in state taxation

In 1971, the Commission developed UDITPA—general business income tax allocation and apportionment regulations. These UDITPA regulations are embodied in Article IV of the *Multistate Tax Compact*. UDITPA rules and regulations seek to properly and, more important, consistently determine the state and local tax liability of multistate taxpayers. The Commission concluded that universal adoption of UDITPA would not only lead to a more equitable apportionment of the tax base among the states, but would also reduce the likelihood of the taxpayer being subject to duplicative taxation. Most states have agreed, adopting the act in whole or in part.

GENERIC STATE AND LOCAL TAX PLANNING STRATEGIES

Planning may occur in isolation or in conjunction with a planned transaction (e.g., an acquisition of another company by the client). The goal of planning is to optimize/minimize a taxpayer's state and local tax liability. Furthering this goal, planning should never interfere with business operations or objectives; the tax tail should not wag the business dog. This is commonly referred to as the tax neutrality doctrine.

Tax savings arise from a permanent reduction in tax liability or a temporary postponement of liability. The savings arising from the former are obvious. The savings arising from the latter are due to the time value of money. The postponement increases the discounted cash flow of the company by permitting the business to hold onto its money longer. This, in turn, enhances financial statement net income.

For publicly traded firms, the financial statement effect of tax planning is of utmost importance because shareholders and financial analysts can only see the results of tax planning in reductions in the firm's tax expense and effective tax rates. In addition, financial statement impact is important to the firm's decision makers. At most large firms, executive compensation includes bonuses and stock options that are maximized by increasing the firm's financial net income. For the impact on financial statement disclosures, *see* Gupta, S., L. Mills, and E. Towery (2014) "The Effect of Mandatory Financial Statement Disclosures of Tax Uncertainty on Tax Reporting and Collections: The Case of FIN 48 and Multistate Tax Avoidance," *The Journal of the American Taxation Association* 36(2), (Fall), pp. 203–229.

The basic state and local tax planning strategies can be recalled by use of the acronym for state and local tax (SALT): Shifting and splitting, Added value, Location, and Timing and transforming. Tax advisors, consultants, and managers add value to the firm by utilizing these techniques, as in the following examples:

- ❖ **Example 1.1—**A business wants to build a manufacturing plant in a new city, but the local property tax is very high. The business persuades the local officials that the plant will bring many benefits to the city; consequently, the business is able to negotiate a lower property tax rate. The tax cost is *split* between the city and business.
- ❖ **Example 1.2—**A manufacturing firm needs to replace a substantial portion of its aging equipment. The firm plans to purchase $19 million worth of equipment; the purchase would be subject to a 7% sales tax in the firm's state. The sales tax can be paid over time as the lease payments

are made if a subsidiary leasing company is set up that purchases the equipment and then leases it to the manufacturer. Tax savings are created by the use of *shifting* the tax base to an additional entity and by *timing* that causes a reduction in the present value of taxes. (Appendix B is devoted to the concept of present value.)

❖ **Example 1.3—**A corporation forms a subsidiary to sell upper management services to other subsidiaries. The management subsidiary is located in a low tax rate state. The other subsidiaries are located in higher tax rate states. Shifting to a newly created entity creates tax savings because the paying subsidiaries deduct their management fee expenses at a higher tax rate than the management fee income recognized by the management company.

❖ **Example 1.4—**A pharmaceutical company wants to build an assembly plant to service State C. The company is considering two locations: State A, its current state, and State B. State A has a 9% corporate income tax rate; State B has no corporate income tax. The nontax advantages and disadvantages of States A and B are the same. The company decides to build the plant in the tax-free state. The firm saves significant tax dollars by using *location* as a planning technique.

❖ **Example 1.5—**A company's marketing department has decided to switch to a more *push* promotion strategy. To do so, it needs a sales force presence in several nearby states. Sales offices are only located in low-tax-rate states. No business connection or *nexus* is established in high-tax-rate states. The sales force travels into the high-tax-rate states from offices in the low-tax-rate states. Consequently, the company has no tax liability in the high-tax-rate states, as all sales income generated is allocated to, and subject to the taxation of the low-tax-rate states. The firm saves significant tax dollars by using *location* as a planning technique.

❖ **Example 1.6—**A firm is considering expanding its manufacturing facilities in either its current location or in a nearby city. The nearby city has a number of *enterprise zones*. Firms located in such zones not only pay no sales taxes, but they also receive income tax credits for wages paid. If the firm locates in an enterprise zone, it will have *transformed* deductions into credits and taxable sales into nontaxable sales.

❖ **Example 1.7—**Near the end of the year, engineers from the production department approach management about acquiring new production machinery. If state tax rates are scheduled to increase next year, any tax deductions for depreciation taken next year have more cash value than if they were taken this year. Management may adjust the *timing* of the transaction by acquiring the machinery early in the next year.

- ❖ **Example 1.8—**A state offers a $5,000 tax credit to firms for each employee hired if the employee is in a targeted group (i.e., individuals who normally have difficulty obtaining employment). By hiring such employees, a firm would *transform* a deduction into a credit.
- ❖ **Example 1.9—**A manufacturer ships a finished product to a warehouse where the product is then packaged for sale to wholesalers. The packaging is subject to sales tax. Management moves the packaging to the manufacturing plant. This results in the packing materials not being subject to tax because under most state laws any part of the manufacturing process is exempt from sales tax. This results in a transforming of a taxable transaction into a nontaxable transaction.
- ❖ **Example 1.10—**Because business income tax rates vary across jurisdictions, it is possible to benefit from tax-rate arbitrage by using apportionment techniques to reduce tax liability. Location strategies focus on this: all other things being equal, it is better to have income from jurisdictions that impose lower taxes. For organizations operating in jurisdictions that apportion cross-border business income—something that most states do—taxes can be reduced through the use of some simple apportionment techniques.

The goal is straightforward: optimize the amount of income apportioned to a lower tax state. As noted before, most states use a variant of the three-factor Massachusetts formula to divide the business income of multistate firms among the various states involved. Under this formula, total business income is allocated to a particular state in proportion to the relative amount of property, payroll, and sales that the firm had in the state that year. That is, a firm will first calculate the ratio of its payroll within the state to its total payroll. This is done again for property and for sales. Then these three ratios are averaged (some states weight factors differently), and the result is multiplied by total business income. This results in the business income taxed by that state.

Because of formula apportionment, it is often possible to reduce the total state and local income tax of a firm by moving the firm's property and payroll to the lower tax state. (It may be possible to *move* sales, too, but it is much more difficult.) High tax states know about this, and have developed a series of rules to hamper taxpayers' efforts to arbitrage away the higher state tax rates. Usually, a minimum amount of payroll is moved to the lower tax state in order to establish a business connection in the lower tax state, or at least to reduce the business connection with the high tax state. (The business connection is referred to as *nexus*, and is discussed in detail in the following chapters.)

For example, consider a firm that manufactures in State X and sells its product in States X and Y. State X has a corporate income tax rate of 10%, and State Y, 5%. If the firm sells by mail order into State Y, where it does not currently have nexus, it is not subject to State Y income tax. The firm's income generated from sales into State Y is allocated to (and thus taxed by) State X. But if the firm obtains a business license and has sales personnel make regular incursions into State Y, the firm can establish nexus in State Y. The firm will become liable for State Y income tax based on the sales revenue earned there, and this will reduce overall state taxes. To illustrate this, suppose the following facts for the firm:

	State X	**State Y**	**Total**
Sales	\$100	\$100	\$200
Payroll	50	0	50
Property	75	0	75

Corporate taxable income is \$40.

If the firm does not have nexus in State Y, all \$40 of taxable income is taxed by State X. The firm's total tax liability is \$40 × 10% = \$4. If the firm establishes nexus in State Y, the firm must apportion its taxable income between State X and State Y. Assume both states double-weight sales.

Allocation to State X:

Sales	(100/200) × 2 = 100%
Property	50/50 = 100%
Payroll	75/75 = 100%
Average factors = (100% + 100% + 100%)/4 =	75%
State X tax = \$40 × 75% × 10%	= \$3.00

Allocation to State Y:

Sales	(100/200) × 2 = 100%
Property	= 0%
Payroll	= 0%
Average factors = (100% + 0% + 0%)/4 =	25%
State Y tax = \$40 × 25% × 5%	= \$0.50

The firm's total tax liability is \$3.50; that is, (0.50/4.00) or a 12.5% reduction in state and local taxes.

Before employing this technique, the firm should consider other aspects of state and local taxation, as well as considering the costs of making such changes. For example, if the firm seeks to reduce its state income tax liability by redistributing workers or facilities between states, it should consider the following:

- What is the cost of the redistribution?
- What is the cost entailed in setting up the workers or facilities?
- What is the *value added* considering marginal productivity?
- What is the overall impact on the *bottom line*? If earnings decrease and management bonuses or debt covenants are tied to earnings, the tax savings may not be worthwhile.

On a more general level, if the firm seeks to acquire an operation or form a subsidiary in a new state, it should consider the following:

- Does this connection with the new state establish nexus?
- Does the change in apportionment reduce the firm's total state income taxes?
- What are the costs of capital and wages (net of any economic incentives offered) in the new state?
- What are the impacts on productivity, value added, and the bottom line?
- Can there be *splitting* of incentives with the seller? If the seller is in a lower tax bracket, would it be willing to lease the property instead of selling? (This would not eliminate the property factor in most jurisdictions; for leased property, eight times annual rental values are counted as *property* for apportionment.)
- Is the firm willing to pay moving workers (or hire new ones) higher wages to entice them to relocate (join the firm)?
- With regard to timing, does the firm anticipate the same tax rates and rules to remain in place? Consultation with state political analysts may enable some forecasting for at least a few years in the future. If the tax climate becomes less attractive in the near future, the time value of tax savings could actually turn out to be negative.
- What are the transaction costs of acquiring or moving a subsidiary into a new state? Legal and accounting fees, actual transportation costs for personnel and equipment, and other such costs reduce (and could even exceed) the targeted tax benefit.

SCANNING THE CHANGING STATE AND LOCAL TAX ENVIRONMENT

Because the business and tax environment is dynamic, tax planning suggests that it is useful to do (and a tax lawyer, accountant, or other professional consultant's due diligence requires) continuous environmental scanning to anticipate changes that might affect a firm—and then determine how it should react. Specifically, there needs to be a continuous review and analysis of (1) nontax changes in the business environment and (2) tax rule changes, particularly for changes in tax rates and tax credits.

Nontax changes should be the primary focus because they are the most dynamic and typically dominate management decisions. Such changes might necessitate a transaction that requires tax management. For example, if a competitor drops its prices, a firm might respond by outsourcing previously manufactured materials so that it can respond with price reductions. Outsourcing has tax implications, such as gains and losses from sales of assets, changes in property and payroll factors used in allocating income among the states, and elimination of nexus.

Although of secondary importance but much easier to do, scanning for tax rule changes is also important. This is because tax rules constantly change. Sometimes they evolve through deliberate government policy; often the rules change due to administrative and judicial modifications and interpretations. These, too, require tax management.

These scans have become much more effective and less expensive in recent years. Indeed, the web has made it much more practical to continuously monitor changes in the nontax and tax business environment. For example, assume that a county in Texas announces a *no property tax* policy on new investment. If the taxpayer firm's strategic plan is to become a leader in the East Coast market, it makes little business sense to move the firm's plants to Texas. However, it may make sense to move West Coast operations to this specific Texas county. Prior to the web, this law change would have been fairly obscure; it would have been likely that only Texas tax professionals would be aware of it until the change found its way into tax research services—and even then it may have stayed obscure because tax professionals might not know enough to consider looking for the change. Now changes can be posted on websites and search agents can be assigned the duty to automatically look for such changes.

One of the advantages of the web is the vast amount of material on it, particularly primary sources. This especially is the case for state and local taxes. States have found it quite worthwhile—some more than others, some far better than others—to maintain their own websites where they post their own pronouncements, rules, regulations, and statutes, as well as the other official documents that make up the basic rules of state and local taxation. Tax Management in Action 1.1 lists those websites.

TAX MANAGEMENT IN ACTION 1.1

State and Local Tax Websites—Scanning the Changing Tax Environment

Alabama	www.state.al.us	Montana	www.state.mt.us
Alaska	www.state.ak.us	Nebraska	www.state.ne.us
Arizona	www.state.az.us	Nevada	www.state.nv.us
Arkansas	www.state.ar.us	New Hampshire	www.state.nh.us
California	www.state.ca.us	New Jersey	www.state.nj.us
Colorado	www.state.co.us	New Mexico	www.state.nm.us
Connecticut	www.state.ct.us	New York	www.state.ny.us
Delaware	www.state.de.us	North Carolina	www.state.nc.us
Florida	www.state.fl.us	North Dakota	www.state.nd.us
Georgia	www.state.ga.us	Ohio	www.state.oh.us
Hawaii	www.state.ha.us	Oklahoma	www.state.ok.us
Idaho	www.state.id.us	Oregon	www.state.or.us
Illinois	www.state.il.us	Pennsylvania	www.state.pa.us
Indiana	www.state.in.us	Rhode Island	www.state.ri.us
Iowa	www.state.ia.us	South Carolina	www.state.sc.us
Kansas	www.state.ks.us	South Dakota	www.state.sd.us
Kentucky	www.state.kt.us	Tennessee	www.state.tn.us
Louisiana	www.state.la.us	Texas	www.state.tx.us
Maine	www.state.me.us	Utah	www.state.ut.us
Maryland	www.state.md.us	Vermont	www.state.vt.us
Massachusetts	www.state.ma.us	Virginia	www.state.va.us
Michigan	www.state.mi.us	Washington	www.state.wa.us
Minnesota	www.state.mn.us	West Virginia	www.state.wv.us
Mississippi	www.state.ms.us	Wisconsin	www.state.wi.us
Missouri	www.state.mo.us	Wyoming	www.state.wy.us

Although these sites are loaded with official documents, which usually are the key sources to be used in courts when litigating tax cases, the sites suffer from the main malady of the web; that is, the data provided are unedited, poorly indexed, and too voluminous to be effective. This particularly is the case when one's goal is simply to scan the changing state and local tax environment. In such cases, it makes sense to work through gateway websites such as those listed in Tax Management in Action 1.2. These not only strive to contain links to other useful sites and organize these links so that they are more useful, they also contain secondary material, such as articles and news bulletins. Although not official, these sources help organize the information (albeit at the price of the editor's bias) and thus often are far more useful in an environmental scan than official sources.

TAX MANAGEMENT IN ACTION 1.2

Gateway Resources on the Web

Deloitte and Touche	http://www.dttus.com/dtti/home.htm
Ernst and Young	http://www.ey.com/
KPMG International	http://www.kpmg.com/
PricewaterhouseCoopers	http://www.pwc.com/
Accounting Resources	http://www.rutgers.edu/Accounting/raw/
Accounting Research Network	http://www.ssrn.com/ARN/index.html
American Institute of Certified Public Accountants	http://www.aicpa.org/
Corporate Financial Reports	http://www.investorama.com/corp.html
Securities & Exchange Commission, Edgar Data Base	http://www.sec.gov/edgarht.htm

STATE AND LOCAL TAX RESEARCH

State and local tax research is done much like that for federal tax research. The biggest difference is the sheer number of different rules from the multitude of jurisdictions involved and that few states and no local jurisdictions are blessed with good, detailed reference works to be consulted.

There are some, however. As suggested by its title, Swenson, C. (Ed.) *State and Local Taxation* (Lexis/Nexis Matthew Bender) is a two volume treatise devoted to state and local tax issues. Other highly regarded works are the state tax services that supplement federal tax services—such as those published by Commerce Clearing House and RIA-Prentice Hall (see also Appendix A).

More important, the leading federal tax publishers put out a variety of handbooks annually for the dozen states that generate the most state and local tax revenues. Also published are multistate handbooks; the Commerce Clearing House equivalent is its *All States Tax Handbook*. These books are an invaluable resource. They typically contain the law up to the early part of November of the prior year. The year of the book is the tax return preparation year. That is, the 2019 edition is what tax practitioners use during the 2019 tax season when preparing 2018 tax returns.

One of their finer features is that they are extensively cross-referenced into the publishers' respective *State Tax Reporters*. These multivolume sets contain extensive detail on almost every aspect of each state's tax law, including the text of the actual laws; headnotes to cases, regulations, and rulings; and the text of current cases.

Another useful feature of a state guidebook is constant cross-referencing, both to the state tax law statutes that are relevant to the discussion and to the comparable IRC Sections. These tables also indicate if there are no comparable sections. This is important because most states provide that if there are no specific state rules or regulations relating to a particular topic, taxpayers can rely on federal law if the underlying statutes are the same.

These cross-references have another useful feature: the Code Sections are in turn cross-referenced into the relevant paragraph of the publishers' *Federal Tax Reporter*. Also included are highlights of new developments and the major tax legislation for the year, tax rates and tables for the major taxes, and cross-reference tables to paragraphs within the guidebooks.

For example, if one knows the section number of the comparable federal law on a point of interest, a guidebook's *Federal-State Cross Reference Table* can be consulted to find the applicable state tax section, and it provides a reference into the publishers' state guidebook paragraph that deals with that specific Code Section. Also provided are a topical index, a table of cases, and a table of legal rulings. One important development is that, at least for some publishers, the same topics appear at the same paragraph numbers in each state's guidebook. Thus, often, once a topic is found for one state, it is easily found for all states.

Speaking of rulings by tax agencies, this brings up an important point about finding state tax rules. Most states have relatively little official and unofficial written guidance. This is not so for some states, such as New York and California. In these states, there are a mass of official guides, including regulations, rules, and rulings, along with extensive publications. In these, significant new rulings, court decisions, and decisions of the state tax agency are pointed out in the state guidebook.

There are also many unofficial sources, such as reporters, treatises, and services that package state tax law for practitioners. Just like those for federal tax rules, some are standard tax reporters, and others are more like tax encyclopedias. There are some multivolume treatises as well as newsletters published by both the state taxing authority and private firms. Additional state and local tax research resources are provided in Appendix A.

DISCUSSION QUESTIONS

1. What are the most important state and local taxes in your state?
2. Your sister is thinking about starting a web-based business—selling specialty teas to upper middle class American women who are working outside the home for compensation. If the business is to start up in

three months, what key decisions will your sister face during that period and how might state and local taxes impact those decisions?

3. You work for a family-owned business located in Coos Bay, Oregon, which manufactures prefabricated metal structures. The owner's granddaughter has just started college at McGill University in Quebec, and he has promised to pay half of her costs, provided she majors in engineering and works for the business after she graduates. Over lunch, he asks you to find out whether he should pay his half from his personal accounts or put her on the payroll. What state and local tax issues should be considered in making this decision?

PROBLEMS

Problem 1.1

How would your answer to Question #2 change if your sister is willing to move anywhere in the U.S.?

Problem 1.2

Galadriel Elvin, a wealthy entrepreneur, is returning home after taking the eldest of her three children to start college on the other side of the country when she notices that the person sitting next to her in the first-class cabin is absent-mindedly fiddling with a pink substance. When she asks about it, Bill Halfacre explains that he has developed it because he is spending a small fortune on batteries for his young children's toys. Simply dipping regular alkaline batteries in the substance for an hour has proven to more than double the effective life of the batteries.

When Galadriel mentions that this is a great idea, Bill replies that he is a bit depressed because he has been trying to connect with someone who can help him develop and market the product, but has been unsuccessful. Galadriel encourages him, and discovers that he has lived a varied and interesting life. He had earned several degrees in chemistry, but had spent all of his time since graduating surfing throughout the world and tinkering with various inventions. (He inherited enough money that he has not had to work since he finished school five years ago, but the money is running out.)

By the time the plane lands, Galadriel and Bill have set a time to meet with Galadriel's lawyer, Elsa Treebeard, to discuss a venture to market Bill's products. They have also invited one of Galadriel's colleagues, Jim Pippin, to attend the meeting. Jim has worked with Galadriel on several occasions; he makes a lot of money, but keeps very little of it. He is a marketing whiz who has strong connections to several distributors to large office supply outlets. Galadriel's concern with Jim has always been that he plays things a bit fast and loose.

At the meeting with Elsa, the group develops projections of profits and losses for the first five years of the business. The expectation is that annual losses will range from $100,000 to $200,000 over these five years, with break-even occurring in about year five. The business will be capitalized with about $200,000 in cash, along with computers, equipment, furniture, and fixtures (fair market value of $100,000 and basis of $25,000) contributed by Galadriel. Bill will contribute the patent at an agreed value of $150,000. Jim has nothing to contribute but time. He will receive a 25% interest for contributing all of his time for a year to get the business going. Thereafter, he will be compensated based on sales and profits. Elsa believes they will be able to borrow $200,000 initially and perhaps an additional $100,000 per year during the development period. The money will be used for working capital and manufacturing equipment. They feel that they may be able to attract new investors once some of the initial work has been completed.

Galadriel thinks Jim brings some needed talents to the venture, but she is very uneasy about being exposed to liabilities that he might create. Bill says he has nothing to lose, so the association with Jim does not concern him. Galadriel has about $500,000 in income each year. Bill's income is about $25,000 a year, and Jim has earned anywhere from $0 to $200,000 annually over the last few years.

How should state and local taxes impact the major strategic decisions faced by the three entrepreneurs as they start up the business?