2023 Year-End Guide – State and Local Tax

With thousands of taxing jurisdictions, from school boards to counties and states, and many different types of taxes, state and local taxation is complex. Each tax type comes with its own set of rules — by jurisdiction — all of which require a different level of attention.

This article provides a high-level overview to help companies with 2023 year-end SALT planning considerations, and it provides guidance on how to hit the ground running in 2024.

Liquidity Events

Liquidity events take the form of IPOs; financings; sales of stock, assets, or businesses; and third-party investments. Those events involve different forms of transactions, often driven by business or federal tax considerations; unfortunately, and far too often, the SALT impact is ignored until the 11th hour or later.

A liquidity event is not an occasion for surprises. When a taxpayer is contemplating any form of transaction, state and local taxes should not be overlooked. Knowledgeable SALT professionals can help identify planning opportunities and point out potential pitfalls, and it is never too early to involve them. If you wait until after the transaction occurs or until the state tax returns are being prepared, it may be too late to leverage their insight.

From state tax due diligence to understanding the total state tax treatment of a transaction to properly reporting and documenting state tax impacts, addressing SALT at the outset of a deal is critical. If involved before the year-end liquidity event, SALT professionals can suggest helpful adjustments to the transaction that may be federal tax-neutral but could result in identifying significant state tax savings or costs now, rather than later. After the liquidity event, because the state tax savings or costs already have been identified, they can be properly documented and reported post-transaction. Further, because SALT expertise was involved at the front end, state tax post-transaction integration, planning, and remediation can be more seamlessly pursued.

Income/Franchise Taxes

If anything has been learned from the last six years of federal tax legislation, it's that state income tax conformity cannot be taken for granted. While states often conform to myriad federal tax provisions, it's important to verify S corporations are treated as such by each state they operate in. Further, S corporations must confirm that their status applies to state income taxes. Not asking those questions early can lead to a misunderstanding and potential issues later.

Several states don't conform to federal entity tax classification regulations. Some, including New York, require a separate state-only S corporation election. New Jersey now allows an election out of S corporation treatment. Making those elections — or not — can lead to different state income tax answers, so it's important to understand the available options before the transaction occurs.

Asking important questions early can help provide clarity in the decision-making process:

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- If the liquidity event will result in gain, how is the gain going to be treated for state income tax purposes?
- Is it apportionable business gain or allocable nonbusiness gain?
- Is a partnership interest, stock, or asset being sold?
- How will the gain be apportioned?
- Was the seller unitary with the partnership or subsidiary, or did the assets serve an operational or investment function for the seller?
- Will the gross receipts or net gain from the sale be included in the sales factor, and, if so, how will they be apportioned?

Those are just some of the questions that are never asked on the federal level because they don't have to be. But they are material on the state level and, again, are unwelcome surprises.

Sales/Use Taxes

Most U.S. states require a business to collect and remit sales and use taxes even if it has only economic, and no physical, presence. Remote sellers, software licensors, and other businesses that provide services or deliver their products to customers from a remote location must comply with state and local taxes.

Left unchecked, those state and local tax obligations — and the corresponding potential liability for tax, interest, and penalties — will grow. Moreover, neglecting your sales and use tax obligations could result in a lost opportunity to pass the sales and use tax burden to customers as intended by state tax laws.

A company could very well experience material sales and use tax obligations resulting from a sale, even though the transaction or reorganization is tax free for federal income tax purposes. To avoid any material issues, several steps should be taken:

- Determine nexus and filing obligations;
- Evaluate product and service taxability;
- Quantify potential tax exposure;
- Mitigate and disclose historical tax liabilities;
- Consider implementing a sales tax system; and
- Maintain sales tax compliance.

Real Estate Transfer Taxes

Most states impose real estate transfer taxes (RETTs) or conveyance taxes on the sale or transfer of real property, or controlling interest transfer taxes when an interest in an entity holding real property is sold. Few taxpayers are familiar with RETTs, and the complex rules and compliance burdens associated with those state taxes could prove costly if they are not considered up front.

State PTE Tax Elections

Roughly 35 states now allow pass-through entities (PTEs) to elect to be taxed at the entity level to help their residents avoid the $10,000 limit on federal itemized deductions for state and local taxes known as the "SALT cap." Those PTE tax elections are much more complex than simply checking a box to make an election on a tax return. Although state PTE tax elections are meant to benefit the individual members, not all elections are alike, and they are not always advisable.

Before making an election, a PTE should model the net federal and state tax benefits and consequences to the PTE — for every state in which the PTE operates, as well as for each resident and nonresident member — to avoid potential unintended tax results. A thorough evaluation of whether to make a state PTE tax election (or elections) should be completed before the end of the year, modeling the net tax benefits or costs, as should a determination of timing elections, procedures, and other election requirements (e.g., owner consents, owner votes to authorize the election, and partnership or LLC operating agreement amendments). If those steps are completed ahead of time, then the table has been set to make the election in the days ahead.

When considering a state PTE tax election, one of the most important issues to evaluate is whether members who are nonresidents of the state for which the election is made can claim a tax credit for their share of the taxes paid by the PTE on their resident state income tax returns. If a state does not offer a tax credit for elective taxes paid by the PTE, then a PTE tax election could result in additional state tax burden that exceeds some members' federal itemized deduction benefit ($0.37 is less than $1.00). Therefore, as part of the pre-year-end evaluation and modeling exercise, PTEs should consider whether the election would result in members being precluded from claiming other state tax credits — which ordinarily would reduce their state income tax liability dollar for dollar — in order to receive federal tax deductions that are less valuable.

Does P.L. 86-272 Still Exist?

P.L. 86-272 is a federal law that prevents a state from imposing a net income tax on any person's net income derived within the state from interstate commerce if the only business activity performed in the state is the solicitation of orders of tangible personal property that are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the state.

The Multistate Tax Commission (MTC) adopted a revised statement of its interpretation of P.L. 86-272 which, for practical purposes, largely nullifies the law's protections for businesses that engage in activities over the internet. To date, California and New Jersey have formally adopted the MTC's revised interpretation of internet-based activities, while Minnesota and New York have proposed the interpretation as new rules. Other states are applying the MTC's interpretation on audit without any notice of formal rulemaking.

Online sellers of tangible personal property that have previously claimed protection from state net income taxes under P.L. 86-272 should review their positions. Online sellers that use static websites that don't allow them to communicate or interact with their customers — a rare practice — seem to be the only type of seller that the MTC, California, New Jersey, and other states still consider protected by P.L 86-272.

The effect of the MTC's new interpretation on a taxpayer's state net income tax exposure should be evaluated before the end of the year. Structural changes, ruling requests, or plans to challenge states' evolving limitation of P.L. 86-272 protections applicable to online sales can be put into place.

However, nexus or loss of P.L. 86-272 protection can be a double-edged sword. For example, in California, if a company is subject to tax in another state using California's new standard, then it is not required to throw those sales back into its California numerator for apportionment purposes.

Property Tax

For many businesses, property tax is the largest state and local tax obligation and a significant recurring operating expense that accounts for a substantial portion of local government tax revenue. Unlike other taxes, property tax assessments are ad valorem, meaning they are based on the estimated value of the property. Thus, they could be confusing for taxpayers and subject to differing opinions by appraisers, making them vulnerable to appeal. Assessed property values also tend to lag true market value in a recession.

Property tax reductions can provide valuable above-the-line cash savings, especially during economic downturns when assessed values may be more likely to decrease. The current economic environment amplifies the need for taxpayers to avoid excessive property tax liabilities by making sure their properties are not overvalued.

Annual compliance and real estate appeal deadlines can provide opportunities to challenge property values. Challenging real property assessments issued by jurisdictions within the appeal window may reduce real property tax liabilities. Taking appropriate positions on personal property tax returns related to any detriments to value could reduce personal property tax liabilities. Planning for and attending to property taxes can help a business minimize its total tax liability.

Conclusion

There are 50 states and thousands of local taxing jurisdictions that impose multiple different tax types. Ensuring that your company is in compliance with those state and local taxes — and only paying the amount of tax legally owed — can help reduce your total tax liability. As a taxpayer, it is more efficient to be proactive, rather than reactive, when it comes to state and local taxes. Being proactive will help identify issues and solutions that can be applied to other taxing jurisdictions, as well as helping limit audits, notices, penalties, and interest.