

Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*sm

April 2011

State Taxes Can Crimp Your Cash Flow



If your company does business solely in one state, it probably owes tax to that state as well as to the federal government. Many companies, however, operate across state lines, and therefore may owe tax to more than one state. In the current economic slowdown, some states are endeavoring to address tax shortfalls by aggressively seeking more tax from companies based in other states.

Types of tax

State taxes come in several categories. The most common include

- ❖ **income taxes.** If your company has net income from operations within a state, that state may tax those profits.

- ❖ **sales taxes.** These taxes generally are imposed on the retail sale of goods (that is, when goods are sold to an end user). The buyer usually pays this tax, but the seller is ultimately responsible for collecting the tax and remitting the money to the state.
- ❖ **use taxes.** Buyers who avoid sales tax on a purchase will generally owe a use tax on it. A *use tax* is a tax on the storage, use, or consumption of tangible personal property within a state. In some states, use taxes also apply to purchases of certain services. Use taxes are complementary to sales taxes; if a taxpayer pays sales tax on an item or service, it will be exempt from use tax.

For example, suppose a company based in Maine purchases goods from a supplier located in Massachusetts and uses the goods in Maine. If the company in Maine does not pay a sales tax, it will owe a use tax. Use tax rates are the same as sales tax rates.

- ❖ **other taxes.** States sometimes also employ a variety of other taxes in addition to or in place of the taxes discussed previously. These include franchise taxes, which are taxes

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Top Tax Rate

California has the highest state sales tax in the U.S., at 8.25%, but local taxes in many states can bring the total even higher.

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Trusted Advice

Voluntary Disclosure

- Companies may discover that they had nexus in a given state and thus owe back taxes.
- Most states allow voluntary disclosure agreements (VDAs). These agreements call for the company to submit delinquent tax returns and pay the required taxes.
- Typically, a VDA will limit the lookback period to three or four years. No penalties will be assessed if the company pays taxes in full for those years.

imposed for the privilege of doing business in that state, and taxes on a taxpayer's gross receipts.

Complex connections

Even if your company has some out-of-state activity, it may not owe any or all of these taxes to every state in which it operates. Generally, your company's tax obligation will depend on whether its activities

in a given state are sufficient to create *nexus*. This term describes a connection to a state that reaches a level justifying taxation. If a company has nexus with a state with regards to a particular type of tax, it will be subject to that tax in that state.

While the principle of nexus is easy to understand, determining when a business has nexus with a state for a specific type of tax can sometimes be anything but easy. Within broad parameters prescribed by the U.S. Constitution and certain federal laws, each state can set its own nexus standards, and these standards can vary widely from state to state. Also, within the same state, the standards for nexus for one type of tax can be significantly different than for another type of tax. In addition, because the ways that companies do business are constantly changing (for example, selling through the Internet and employing telecommuters), and the states are constantly seeking to expand the boundaries of nexus in order to increase their potential tax base, the rules in this area are seldom stable. Activities or situations that in the recent past may not have been a source of nexus with a particular

state may now or in the future result in a company's being taxed by the state.

The bottom line is that states differ in what they consider nexus, and the rules in the area are continuously evolving. Due to the very serious repercussions that having nexus with a state can cause, many cases challenging a state's assertion of nexus have come before different states' courts, with varying outcomes. Before you expand your operations beyond your home state, check the nexus laws of the new states in which you are planning to do business and decide whether the business opportunities justify the potential tax cost. Our office can help you learn about the nexus rules in states your company has targeted for business. ■

Did You Know?

Precious metals mutual funds returned nearly 42% in 2010, on average. For the 10 years through December 2010, precious metals funds had annualized returns over 25%.

Source: Morningstar

Plan Now for Expanded 1099 Reporting

Business owners probably are familiar with IRS Form 1099. If you pay an independent contractor \$600 or more in a given year, you are required to report those payments to the IRS on Form 1099-MISC. Suppose, for example, you paid Jane Brown \$2,000 for some consulting work in 2010. By January 31, 2011, your company was required to send copies of Form 1099 to Jane and to the IRS, reporting the \$2,000 payment. Such reporting may help the IRS match Jane's reported income to her actual income and,

thus, bolster compliance with the tax law.

Piling on the paperwork

Last year's health care law contains provisions that will expand 1099 responsibilities. Starting with payments made in 2012, the new law requires your company to send out 1099s for payments made to corporations (and not just to individuals), if your company has paid \$600 or more in aggregate in a given year to a corporation (other than a tax-exempt corporation).

Generally, your company will not have to file 1099s for payments to corporations in 2011. In addition, starting in 2012, 1099s will be required for payments for property that meet the threshold and not just for services.

Your company's 1099 responsibilities will increase greatly, however, assuming this provision is unchanged this year. (There have been attempts in Congress to repeal this law before it becomes effective next year.) What's more, your company will have to obtain a tax

identification number (TIN) from each vendor from which it buys at least \$600 worth of goods or services. With TINs, you can properly fill out the required 1099s. For vendors that refuse to comply with your request for a TIN, you will be required to withhold 28% on any payments and

send that amount to the IRS, as backup withholding.

Therefore, it is crucial that your company begin the process of sending out TIN requests to all vendors this year. Establish procedures for tracking outlays and for handling backup withholding, when required.

Make sure your company fills out all the TIN requests it receives so that it won't be subject to this 28% shortfall on payments you receive. The process can be tricky and time-consuming, so don't hesitate to call our office for assistance. ■

Deduct, Don't Depreciate

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 focused mainly on personal income and estate tax. Nevertheless, some additional provisions may be helpful to businesses.

In particular, the new law enhances the Section 168(k) bonus depreciation provisions by temporarily allowing 100% first year bonus depreciation of new business equipment that qualifies for bonus depreciation. That is, a company that purchases qualifying depreciable assets may deduct the entire cost of the assets right away. First-year deductions will immediately boost a company's cash flow, compared with taking depreciation deductions over several years. No limits exist on the amount of qualifying equipment purchased that is eligible for the 100% deduction.

This 100% deduction provision is effective for qualifying equipment placed in service from September 9, 2010, through the end of 2011. As a

result, any company or self-employed individual who has bought or might buy business equipment has several sets of rules to consider.

One law passed in 2010 set permitted first-year Section 179 deductions (expensing) at \$500,000 worth of equipment. The phaseout threshold was set at \$2 million, meaning that companies buying more than \$2 million of equipment in 2010 lost some expensing opportunities. Thus, you might be able to use Section 179 expensing for up to \$500,000, for equipment placed in service by September 8, and Section 168(k) 100% bonus depreciation for equipment placed in service after that date last year.

For 2011, equipment purchasers can use either expensing (\$500,000 limit, \$2 million phaseout threshold), 100% bonus depreciation, or some combination of the two.



The new law also calls for 50% bonus depreciation in 2012, along with a \$125,000 limit for expensing and a \$500,000 phaseout threshold.

The bottom line? The interaction of these two code sections (Section 179 expensing and Section 168[k] bonus depreciation) provides opportunities as well as complications. Our office can help you decide how to handle those decisions on your 2010 tax return (amended, if necessary) and plan for equipment purchases over the next two years. ■

Be Sure About Beneficiaries

As described in the March 2011 *CPA Client Bulletin*, the new tax law greatly reduces exposure to federal estate tax for most individuals and families. However, the new law does not remove the need for all estate planning. You'll need a thoughtful estate plan to ensure that your assets go to the desired recipients with

a minimum of time, expense, and contention.

Your estate plan should begin with a will that was drafted by an experienced attorney. Whenever there is a major change in the law—such as for this year—you should review your will to make sure it still expresses your wishes. The same is true after

major life events: births, deaths, marriage, and divorce.

Beyond your will

You also should be aware that some assets generally do not pass under your will. Instead, they will go to a beneficiary you name. That's true for employer-sponsored retirement

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plans, individual retirement accounts (IRAs), life insurance policies, and annuities. Some investment accounts and savings accounts also belong to this group if they are transfer-on-death or payable-on-death accounts.

To see how this might work, suppose that Dan Smith creates an IRA when he begins his working career. He names his sister, Beth, as the beneficiary. Many years later, Dan has a substantial amount in his IRA, as well as other assets. When Dan creates a will as part of his estate plan, he states that all of his assets should go to his nephew, who is supporting a family on a modest income. Dan does not include his sister in his will because Beth has substantial assets of her own.

However, Dan has neglected to change his IRA beneficiary, in this scenario. At his death, his IRA will pass to Beth, who is still the

designated beneficiary. For Dan's IRA assets, his will is disregarded.

Supreme Court's view

If you think the Dan Smith example is unlikely, consider this real-life story. An employee at a major U.S. corporation was divorced. In the divorce agreement, the employee's wife relinquished all claims to his company benefits. The employee, however, did not change the beneficiary designation on his account in the company's savings and investment plan.

The employee died several years later, with about \$400,000 in this plan. The company paid all the money to the ex-wife, who was still the designated beneficiary. The deceased employee's estate sued the company, and, in 2009, the



U.S. Supreme Court unanimously ruled for the company (*Kennedy v. Plan Administrator for DuPont*). The employee's failure to revisit his beneficiary selections thwarted his estate plan.

Check and keep checking

As previously mentioned, you should create a will and revisit it periodically. The same is true for your beneficiary selections. Check them at regular intervals to make sure that the people you have named are still the ones you'd like to inherit those assets. ■

TAX CALENDAR

APRIL 2011

April 18

Individuals. File a 2010 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, or you can get an extension by phone or over the Internet. Then, file Form 1040, 1040A, or 1040EZ by October 17.

If you are not paying your 2011 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2011 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of \$1,700 or more in 2010 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of \$1,000 or more in any calendar quarter of 2009 or 2010 to household employees. Also report any income tax you withheld for your household employees.

Partnerships. File a 2010 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), *Partner's*

Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 15.

Electing large partnerships. File a 2010 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 17.

Corporations. Deposit the first installment of estimated income tax for 2011.

MAY 2011

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2011. This due date applies only if you deposited the tax for the quarter in full and on time.

May 16

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.