THE PITFALLS OF STATE AND LOCAL TAXATION FOR STARTUP COMPANIES

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In today's business environment where innovation and technology converge and the modern day entrepreneur has more support and incentive than ever to begin their dream startup company, more often than not discussions about state and local business taxes have a similar tone:

- The company is losing money; we don't owe any taxes.
- The sale of software isn't subject to sales tax.
- Our product is delivered electronically; sales tax doesn't apply to us.
- We only have work-from-home employees outside of our home state; we aren't subject to tax in other states.

These assumptions can create financially material pitfalls for companies with a false sense of security in the current business environment wherein remote workforces, professional employer organizations (PEO), and technology are being increasingly implemented and relied on to operate a business across the country and abroad. Oftentimes the state and local tax implications of these flexible and modern business decisions are overlooked and minimalized in light of the ever-changing laws and guidance passed and issued by the state tax authorities that try to ensure that companies "doing business" in their jurisdiction, even via service-based technologies, are contributing to the state coffers via taxation. These tax liabilities, which many companies believe don't exist, can turn into a heavy burden in the event that a company seeks investors, financing, IPO or sale.

Federal constitutional provisions that impact the states' ability to subject an out-of-state company to income tax or to impose a sales and/or use tax collection responsibility on a company do exist. The power of a state to do either is limited mainly by the "Due Process Clause" and the "Commerce Clause" of the United States Constitution. These federal provisions direct that in order for a state to constitutionally impose tax on an out-of-state business, there must be a minimal connection, or nexus, between the state and the company it is seeking to tax. If a company does not have nexus in a state, it would be unconstitutional for the state to impose any type of tax (e.g., an income tax or a sales tax collection responsibility) on that company.

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Startup companies have to pay close attention to state income and sales tax nexus created by two prevalent factors: The remote workforces that potentially give a company physical presence in a state even if those employees are hired through a PEO; and economic presence standards. Additionally, changing legislation with regard to remote sellers (e.g., internet-based businesses with interstate sales) is becoming increasingly popular by states and increasingly burdensome for taxpayers.

A company's physical presence can be measured by employees or contractors working or traveling into a jurisdiction on behalf of the company for more than a de minimis amount of days (e.g., more than two days). Additionally, the location of a company's tangible property or rented real or personal property are also considered a physical presence that can create nexus. However, while people, property, plant and equipment used to be the main focus of a nexus determination for both income and sales tax, physical presence is no longer the only concern a company must consider when engaging in out-of-state business.

Starting in the '90s with the Geoffrey and MBNA decisions, states have increasingly enacted economic or factor-based nexus provisions that allow a jurisdiction to impose an income tax on any company purposefully engaging in economic benefit within a state, without regard to physical presence. For example, the state of California asserts that a company with gross receipts within the state of $561,951 or more for tax year 2017 may be subject to income tax based on economic presence.

More recently, states have begun to enact similar laws with regard to the imposition of sales and use tax, although arguably this is unconstitutional as held in Quill v. North Dakota, 504 U.S. 298 (1992), which requires "substantial nexus" in the form of property or people to impose sales tax on out-of-state sellers. Alabama, South Dakota, Tennessee, Massachusetts, Vermont and Wyoming have all adopted economic nexus rules effective during 2017 or prior with regard to sales and use tax. Currently, the United States Supreme Court has heard arguments in South Dakota v. Wayfair, Inc. and the Court's decision is pending as to whether or not it will agree with the State of South Dakota and revoke the decision under Quill v. North Dakota, 504 U.S. 298 (1992) which may allow states to constitutionally tax out-of-state sellers with no physical presence within a state.

While companies may focus on both income tax and sales tax, it is also important for startup companies to also consider other non-income-based taxes and the effect that those taxes could have on a company's cash flow, including franchise and net worth taxes, minimum taxes, property taxes and gross receipts taxes, which can all result in a cash tax for a company with operating losses.

Rebecca Stidham is Senior Manager - Tax Services at OUM & Co. LLP and has significant experience with the requirements of jurisdictions in all 50 states applicable to state and local tax liabilities. She has more than eleven years of corporate and pass-through tax compliance experience as a state and local tax practitioner in public accounting, with an emphasis on direct and indirect compliance for companies operating in the technology, SaaS, rental real estate, professional services and venture capital industries.