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State Income Tax Issues for Professional Service Firms

by Gerald A. Shanker

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Facing continuing budget deficits, state governments are seeking additional revenue sources. Many states have raised additional revenue through increased tax collections, primarily by identification of noncompliant foreign entities doing business within the state and nonresident individuals receiving income from sources within the state. Focusing on professional service firms doing business in New Jersey, New York, and Pennsylvania, this article will discuss nexus issues, tax filing requirements, and income allocation methods, as well as the consequences of noncompliance with state tax statutes.

Definition of Nexus

Under longstanding case law, a company generally acquires income tax nexus or sales/use tax nexus in a state if (among other factors) the company maintains a place of business or has employees or other representatives visibly conducting business activities in the state on behalf of the company.[1]

Nexus does not require a regular place of business. In the legal profession, appearance at a deposition or hearing, or attendance at a settlement conference is sufficient to establish nexus and subject the law firm to taxation in the foreign jurisdiction. The New Jersey Superior Court and Appellate Division took it a step further in *Telebright Corp v. Director, Division of Taxation*.[2] Telebright, a Delaware corporation, did not maintain any office or bank accounts in New Jersey or engage in any sales solicitation activity in the state. However, when a Telebright employee moved her residence from Maryland to New Jersey and that employee worked for Telebright from her New Jersey residence, the courts held this activity was sufficient to establish New Jersey nexus.[3]

In the *Telebright* case, the New Jersey employee worked a regular 40-hour week, providing computer-programming services from her New Jersey residence. Technology has made it easy to work at home, and attorneys occasionally bring work home after a day at the office. It is not suggested that this activity is sufficient to create nexus; however, pursuant to the dictates of *Telebright*, working on a regular basis from a New Jersey home office for a law firm in another state would appear to be sufficient.

Law firms and other professional service firms should conduct a thorough review of their activities to determine if foreign state nexus exists. For law firms, such activities include but are not limited to:

- Employees in the state, including those working at home on a regular basis
- *Pro hac vice* admission
- Attendance at a deposition, settlement conference or trial
- Maintaining an office, whether permanent or temporary
- Maintaining property in a state, including leased property

Several years ago, the author assisted partners of a South Carolina law firm who were admitted *pro hac vice* in New Jersey and were contacted by the Division of Taxation regarding the requirement to file New Jersey nonresident income tax returns. It is not difficult for New Jersey or any other state to review court records and cross-check them with tax-filing records to identify potential non-filers.

Consequences of Noncompliance

Statute of Limitations

The statute of limitations period for state income tax audits and deficiency assessments is four years for New Jersey[4] and three years for New York[5] and Pennsylvania,[6] from the later of the tax return due date or filing date. If a filed tax return omits more than 25 percent of gross income, each state's statute is extended to six years from the later of the due date or the date the tax return is filed.[7] In cases of fraud or failure to file a tax return, there is no limitation on the period for state income tax audits and deficiency assessments.[8]

If it is determined a company doing business in a state has not filed tax returns, the period for assessment of tax is unlimited.[9] Even if it can be shown that little or no taxable income is allocable, many states have minimum taxes or maintenance fees, which are payable regardless of taxable income. For many years, New Jersey's minimum tax on corporations was $2,000. With the addition of penalties and interest to this annual tax, the cost of a few years non or delinquent filing can be substantial.

Employment Taxes

Employees are generally subject to state unemployment and income taxes in the state(s) in which they work. Employers are required to register for, withhold, and remit these taxes to the states in which they have employees.[10] Employers also are required to file quarterly and annual payroll tax reporting forms with the states and issue W-2 forms to employees detailing wages earned and tax withheld for each state. The employee is required to file nonresident income tax returns with each state in which he or she worked.[11] Failure by the employer to properly report employee state wages does not relieve the employee of the obligation to file state income tax returns.

Noncompliance with employment tax filing and payment requirements will result in penalties, including those for failure to withhold, pay and file. Also, payment of taxes normally withheld from employees may become the responsibility of the employer if not withheld and remitted.[12]

New Jersey and Pennsylvania have a reciprocal agreement under which residents of one state working in the other state are not required to file a nonresident return with the state of employment.[13]

Pass-through Entity

Pass-through entities are partnerships, S corporations, and limited liability companies electing to be taxed as partnerships or S corporations. With limited exception, these entities are not subject to federal or state income tax. The taxable income or loss of these entities is passed through to its partners or shareholders for inclusion and taxation on their personal income tax returns. This income is reported on federal and state forms K-1, which are included with the federal and state tax return filings and provided to the partners or shareholders for preparation of their personal income tax returns. Employees of pass-through entities are subject to the rules discussed in the preceding section.

A company doing business in a foreign state is required to file an income tax return with that state. If the company is a pass-through entity, each of its partners or shareholders is liable for personal income tax on their share of entity taxable income earned in that state. Absent composite return participation, as discussed below, this income tax is reported and paid by filing a nonresident individual income tax return with each state in which the pass-through entity is doing business. Noncompliance with the reporting and payment of such taxes can result in a costly bill to the partners themselves. In addition to filing annual income tax returns, quarterly estimated tax payment may also be required, and failure to pay state estimated taxes may result in penalties and interest.

Composite Return

A composite tax return is a state income tax return filed by an entity on behalf of all nonresident partners who qualify for and make an affirmative election to participate in the composite tax return. If a partner has taxable income from other sources in the state, he or she will generally not qualify for participation in the composite tax return.

The advantages of participation in a composite income tax return filing are compliance with state filing requirements while saving the time and expense of preparing nonresident tax returns for each state in which the entity is doing business. The disadvantage is that for states with graduated income tax rates, all income reported on the composite tax return is taxed at the highest tax rate imposed by the state.

Implication for Home State Taxes

Whether nonresident state taxes are paid by composite return participation or filing individual nonresident state tax returns, a credit for taxes paid to the nonresident states is taken on the partner's resident state income tax return. The effect of this credit is a reduction of resident state tax for taxes paid to the nonresident state. Whether or not this is a dollar for dollar reduction depends on the resident and nonresident state tax rates, but regardless of the rates the credit will be meaningful with respect to the amount of nonresident taxes paid. The effect of this credit is elimination of double state taxation on the nonresident income. Timely compliance with nonresident state tax statutes comes at little or no additional tax cost.

When a New Jersey resident is required to file a tax return with a nonresident state, he or she will not be permitted to claim a credit for taxes paid to the nonresident state if taxes are later assessed by a nonresident state and the New Jersey credit is not claimed within New Jersey's three-year statute of limitations for refund claims. As disallowance of this credit would effectively result in double state tax, this is a good reason for voluntary compliance with nonresident state tax filing and payment requirements.

In situations where the adjustment of a business entity or individual income tax return filed with a nonresident state is later adjusted by that state, and the adjustment results in additional nonresident state income tax, a special rule suspends the New Jersey statute of limitations on refunds to allow New Jersey resident taxpayers to file amended returns to claim additional credits resulting from adjustment of nonresident state tax returns.

Allocation Methods

Business income is allocated to foreign states pursuant to formulas prescribed by state statute. The New York allocation is based on revenue earned within and without New York. Through Dec. 31, 2013, New Jersey and Pennsylvania both required application of a three-part formula consisting of property, payroll, and revenue within and without the state. Effective Jan. 1, 2014, New Jersey has fully phased in the single sales allocation formula, which is similar to the allocation method required by New York.

Revenue allocation can be a difficult problem for some professional service firms and a source of controversy with state tax authorities. Firms that bill clients based on service hours can use their time and billing systems to track the location where the services were performed, and use this data to allocate revenue among states. However, this may be a problem for firms whose principal revenue source is contingent fees. In the author's experience, contingent fee firms do not maintain detailed time records. The author was unable to identify any New Jersey, New York, or Pennsylvania court decision, regulation, or administrative ruling addressing the allocation of contingent fees among states.

If states identify attorneys' fees from personal injury cases as a source of tax revenue, it will be a simple task for them to review settlement and verdict records to select candidates for tax examination. If that occurs, firms that have complied with foreign state filing requirements, using an income allocation that is rational and supported by documentation, will be more likely to obtain favorable results than a firm that has not. It is important to file tax returns in all states in which the firm is doing business, if only to start the tolling of the statute of limitations. As previously discussed, if a tax return is not filed, the statute of limitations does not expire and state tax may be assessed at any time.

Market Destination Method

As the United States is moving toward a service-based economy, sourcing of service revenue is becoming more important. As of the date this article was written, 13 states have adopted a market sourcing method for revenue allocation. Under the market sourcing method, sales derived from customers within a state are allocated to that state, regardless of where the service was performed, or how much time and/or resources were spent performing the service.

On March 31, 2014, New York State Governor Andrew Cuomo signed into law a tax reform package affecting many areas of tax law. Included in this tax reform package are provisions employing a single sales factor for apportionment of income to New York, and a customer-based approach for sourcing receipts to New York, which requires receipts to be sourced based on the location of the customer.[14]

New Jersey has a proposed regulation that would require market-based sourcing for receipts from the sale of services, effective for years beginning after Jan. 1, 2014. Adoption of this regulation would provide much-needed clarity in the allocation of income from services, as income would be allocated to and taxed by the state in which the client is located.[15]

Effective for tax years beginning after Dec. 31, 2013, sales of services are sourced to Pennsylvania to the extent delivered to a location in the state.[16]

Conclusion

Compliance with foreign state tax statutes has advantages and may be accomplished with little or no additional tax cost and minimal administrative cost. Advantages of compliance include tolling of the statute of limitations and the ability to take a resident state tax credit for taxes paid to nonresident states.

On the other hand, failure to comply has several disadvantages, including assessment of entity and

employment tax penalties and interest, an unlimited statute of limitations for assessment of tax, penalties and interest, and disallowance of the credit for taxes paid to nonresident states if the taxes are paid after expiration of the resident state limitations period for refunds.

State tax examinations often result in arbitrary tax assessments, leaving the burden to prove the assessment incorrect on the taxpayer. As the examination and tax assessment may occur long after the years that are the subject of the audit, it will be difficult or impossible to construct records of transactions taking place in those years, and convince the state tax auditors that the records are accurate. It is preferable to timely file foreign state tax returns that are supported by contemporaneous records. ■

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Endnotes

1. John A. Biek, Establishing State Tax Nexus Through Telecommuting Employees, *Journal of Passthrough Entities* 46, May-June 2012.
2. 424 N.J. Super. 384 (App.Div. 2012), *aff'g* 25 N.J. Tax 333 (2010).
3. *Ibid.*
4. N.J.S.A. §54:49-6(b); N.J.A.C. §18:7-13.1(b).
5. N.Y. Tax Law, §1083(a); N.Y. Tax Law §1083(b); N.Y. Comp Code R. & Regs. Tit. 20, §8-1.2(a).
6. 72 P.S. §7407.3(a), 72 P.S. §7407.3(f).
7. N.J.S.A. §54:49-6(b); N.J.A.C. §18:2-2.6(b); N.J.A.C. §18:7-13(b); N.Y. Tax Law, §1083(c)(1)(A); N.Y. Tax Law, §1083(d); N.Y. Comp. Code R & Regs. Tit. 20, §8-1.2(b)(1)(ii); 72 P.S. §7407.3(b), 72 P.S. §7407.3(c).
8. *Ibid.*
9. *Ibid.*
10. N.J.S.A. §54A:7-1(a); N.Y. Tax Law, §671(a)(1); P.S. §113.1.
11. N.J.S.A. §54A-2-1.1; N.Y. Tax Law, §631; Pa Code Tit. 61, §121.6.
12. N.J.S.A. §54A7-5.
13. NJ Division of Taxation, www.stte.nj.us/treasury/njit25.shtml.
14. S.B 6539-D, A 8559-D (Chapter 15).
15. N.J.A.C. Proposed New Sec. 18:7-8.10A.
16. HB 465, Section 19.