The Economic Crisis and State Revenue Activities

By Diane L. Yetter

The economic crisis is not just impacting businesses and individuals. As we have been hearing in the news, state and local governments are also facing some of the worst budget challenges ever. In many states, the debate is about how much to cut services versus increasing revenue. Individuals and businesses have been very vocal that increasing taxes at this time would just make it harder for them and result in further reductions in state revenue as higher taxes would put them out of business. So, the states are facing real challenges: How can they increase revenues at a time when businesses and individuals are least able to pay?

A recent article in THE NEW YORK TIMES from June 4, 2009 (*www.nytimes.com/2009/06/05/us/politics/05states.html?th&emc=th*) discusses how states' budget crisis is getting worse. Most states overestimated the expected revenue from all tax sources. In fact, half of the states overestimated all three major tax sources: sales tax, personal income tax and corporate income tax.

The National Conference of State Legislators (NCSL) has prepared some interesting reports on the states and their budget to actual results (*www.ncsl.org/documents/fiscal/StateTaxPerformanceJune2009.pdf*).

Sales tax collections in 31 states were below prior year collections; however, sales tax collections were higher year over year in nine states, with North Dakota leading the pack, according to NCSL reports.

So, what are states doing to compensate for the reduced revenue? This article predominantly focuses on how states are responding in the sales and use tax arena.

Variety of Approaches

States have taken a variety of approaches to generate more revenue, including the following:

- Elimination of exemptions (sometimes called "loop-holes")
- Broadening of the tax base to include new areas such as services
- Changes in interpretations of what constitutes "doing business" in the state
- Some rate increases (*e.g.,* Massachusetts just increased its state sales tax from five percent to 6.25 percent effective August 1, 2009.)

In addition, a number of states have proposed and passed amnesty programs as a way to get some quick cash—as well as new taxpayers—in the door. These programs have proven to be very lucrative for the states in the past, and they are all hoping for this trend to continue. Twelve states have or will offer amnesty during 2009. *See www.ycstax.com/news.php#ref4* for current information on amnesty programs.

One of the most visible and controversial approaches is enactment of so-called Amazon laws, which classify affiliates who direct online customers to an out-of-state merchant's Web page to be deemed "agents" of the remote merchant. This activity by the instate agents creates nexus for the out-of-state retailer, which requires them to register and collect sales tax on not only the sales referred to them by the deemed agent but any sales delivered into the state. This law was passed in New York in 2008 and in Rhode Island in 2009; however, other states proposed legislation only to have it vetoed by their governor or tabled after Amazon threatened to sever affiliate programs in the state. This has raised the question of whether the states' actions to add taxpayers to its rolls would increase revenues or actually decrease them, since such a move could put the in-state affiliates out of business.

Increased Enforcement

Another tactic used by states to generate more revenue is increased enforcements. This comes in the form of:

- increased audits,
- more aggressive positions taken by the auditors, and
- more reliance on taxpayers to defend inappropriate assessments.

Most of the companies I have talked to concerning their recent experience have confirmed these efforts by the states. Not only are the states performing more audits, but municipalities have increased their audit efforts as well. These audits include home-rule sales and use taxes and business licenses. These localities are sending audit notices and desk assessments to businesses that have customers in their jurisdiction. Just because a company has a customer in a particular jurisdiction, this doesn't necessarily mean it has a business license requirement. It is critical to evaluate the registration requirements, determine what constitutes nexus under the specific license rules and make sure the company is registered appropriately.

Audits are also starting to include areas on which auditors may have previously passed or only performed a cursory review. For example, areas where taxpayers have seen auditors take much more aggressive positions include the following:

- Requesting exemption certificates for every exempt transaction and being unwilling to check the state's records to see if the entity has a valid exemption
- Requiring receipts that reflect the sales tax on procurement card transactions regardless of invoice amount (including restaurants)
- Reconciliation of gross sales from income tax returns to sales tax returns resulting in assessments for any differences

Another trend that taxpayers are experiencing is shorter and sloppier audits. Historically, auditors would request waivers for six months to a year. However, as states are anxious to collect every penny owed them, waivers are not as easy to request. In fact, auditors are rushing through audits and issuing assessments that have not been reviewed by the taxpayer. This shifts the burden of proving any exceptions from an audit activity to an administrative hearing activity. And these hearings are being dragged out indefinitely—forcing a number of taxpayers to make payments against the audit for the items they agree with to reduce the interest costs.

States are also conducting more desk audits, requiring the taxpayer to do much more of the work. This saves the state travel dollars and auditor time. There is usually no offset of the liability for the taxpayer's efforts.

Tips to Stay Compliant

To help minimize assessments during the audit process make sure all your sales tax rates are current so that sales tax charged to your customers is correct and that you have valid exemption certificates for your exempt customers. With shorter audit cycles, there is less time to obtain these certificates once an audit begins.

Also, if you are in a service business, keep in mind that if you travel to perform services at your customer site, you have likely established nexus and could be subject to not only sales tax, but also income tax. As states look to service activities as new sources of revenue, it will be critical to monitor the laws in the states where you have customers. Conduct a nexus study to determine if you have a liability and, if you do, take advantage of amnesty programs offered by the states. After an amnesty program closes, the state usually steps up its enforcement efforts to identify potential taxpayers that didn't come forward.

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