

TAX TIPS FOR START-UPS: US SALES AND EMPLOYMENT WITHHOLDING OBLIGATIONS

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US SALES AND EMPLOYMENT WITHHOLDING OBLIGATIONS

Tax ranks high among the many structural issues a start-up needs to consider. Even tax responsibilities that seem straightforward – such as collecting sales tax and setting up withholding for employees – can be challenging and need to be approached carefully.

When you start a business, there are certain taxes that you as a business owner and employer are required to withhold and remit to the appropriate taxing jurisdiction. These reflect your responsibilities to the state and federal government. In essence, **the business owner acts as a fiduciary for the government** in collecting and remitting tax payments.

Because **the government entrusts the business owner with collecting its tax payments**, there are strict compliance penalties that will be enforced against you and all responsible persons if the taxes are not remitted. In some instances, these remittance failures can lead to criminal prosecution. These penalties are called "trust fund" penalties or "responsible person assessments." A "responsible person" is any person that has the responsibility or authority to ensure the collection and remittance of the applicable tax. Sales tax and employment tax are the two main types of taxes for which trust fund penalties exist.

Trust fund penalties are assessed against individuals rather than the business. Generally, they amount to 100 percent of the outstanding tax owed to the government. In other words, **you are personally liable, as well as your business being liable, for the full taxes owed which can put your personal holdings at risk.**

Determining your tax exposure – and thus your fiduciary responsibilities – is a serious and consequential matter. It requires technical knowledge of tax codes and laws. Expertise – inside the company or outside – is essential if you want to be sure you are meeting all your fiduciary obligations.

Sales Tax is Tied to a Physical Location – Even If Your Product Isn't Physical

Collecting sales tax may seem uncomplicated, and sometimes it is – you sell an item in a given location and you are therefore responsible for the state sales tax that applies. But sometimes matters are less clear

The first step in establishing your sales tax exposure is to determine in which states your business is liable for collecting and remitting sales tax. A state cannot impose the duty to collect and remit sales tax unless your business has the requisite connection with that specific state. Technically, this connection is known as a "nexus."

The question of what constitutes tax nexus is complex. It is defined by constitutional law and state statute. To complicate it further, the definitions vary from one state to the next. The definitions are also affected by federal law, which grants exemptions for certain kinds of activity.

- Broadly speaking, **nexus exists if your business engages in sufficient amounts of pre-defined activities within state borders.**
- For sales tax purposes, we can safely say that **a sales tax nexus exists if your company has a physical connection with the state.**

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If it is determined that your business has the requisite sales tax nexus, you then need to determine if that state imposes sales tax on your specific product.

In the past, sales tax applied to tangible personal property. But what about the intangibles that are often produced by start-ups – software and services, for example? Computer software, e-commerce and computer services are areas of tax law that continue to evolve.

As technology progresses, states continue to update their tax regimes to keep pace. **The sudden evolution of computer software and e-commerce has pushed many states to re-define what constitutes tangible personal property.**

The taxability of computer software can depend on:

- Whether it is delivered electronically or in tangible form.
- Whether it is sold versus licensed to your customer.

Most states also differentiate between taxable and exempt software, by determining whether the software is "canned" (i.e., "off-the-shelf") or "customized." Customized software may be defined narrowly as meeting the needs of one customer or it may include "off-the-shelf" software that is modified for a specific customer.

Bottom line: if your product is taxable in a state and you have sales tax nexus, you must collect and remit sales tax from your customers in that state. This is likely to be the case even if the product is software, a service or some other intangible.

You Must Withhold Both Federal and State Employment Tax For Your Employees

Employment tax withholding applies to most employees. When applicable, you must withhold both federal and state employment taxes. There are requirements, risks and considerations for each.

At the federal level, an employer generally must withhold federal income tax from its employees' wages. The withholding includes a portion of Social Security and Medicare taxes.

In addition, there is Federal Unemployment Tax (FUTA), which is reported separately from federal income tax and Social Security and Medicare taxes. The FUTA responsibility is solely that of the employer. The employees do not pay this tax themselves or have it withheld from their pay.

Withheld Employment Taxes Do Not Belong to You – Even Before You Send It to the Government

As with sales tax, employment taxes are considered to be held in trust. To encourage prompt payment of withheld income and employment taxes, Congress passed a law authorizing the Trust Fund Recovery Penalty (TFRP). The Trust Fund Recovery Penalty can be assessed against any responsible person who willfully fails to pay these taxes. Keep in mind that the term "responsible person" is a broad category that encompasses a wide range of individuals, including you and other officers of your company. It can even reach to other entities.

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Caution: Classifying Employees As Independent Contractors to Reduce or Eliminate Withholding Obligations May Be Disputed

The withholding requirements may lead an employer to classify its workers as independent contractors. When a worker is an independent contractor, the employer is no longer obliged to withhold employment tax and reduces its reporting obligations as well.

However, be aware that:

- Classifying a worker as an independent contractor does not guarantee that the Internal Revenue Service and other taxing authorities will accept this classification.
- Taxing authorities are increasingly challenging these classifications.

Therefore, it is **important for a company to go through a thorough analysis of whether a worker should be classified as an employee as opposed to an independent contractor.** If the government is successful in reclassifying a worker as an employee, the employer can be subject to penalties for failing to withhold taxes, including during the time it classified the worker as an independent contractor.

State Employment Tax Withholding Depends on Business Activity within a State - Workers in Remote Locations Can Complicate Your Tax Picture

Thanks to technology, start-up employees rarely remain confined within the borders of one state. When a company starts sending employees into other states to perform services or employs residents of other states, the company may be required to withhold employment tax for those states on those employees.

As with sales tax, a state cannot require a company to withhold employment tax unless the company has established nexus. When it comes to employment tax, nexus can be established as the result of:

- A business location.
- An employee's regular performance of services within a state.

Once nexus is established, most states require withholding on employee wages that are sourced to that state.

It is difficult, if not impossible, to reduce this exposure. In many states, there is no defined minimum level of contact with the State, below which withholding would be unnecessary. In those states, having an employee work for even as little as one day would trigger a withholding responsibility on the part of the employer.

Other states use different methods to determine if an employer has withholding tax responsibility for its employees. These thresholds can be based on the number of days an employee visits a state or the amount of an employee's wage income resulting from the services within that state.

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Don't Forego a Detailed Analysis of Your Obligations

Determining your company's obligations to withhold taxes based on nexus standards and individual state rules requires a complex analysis. Since failing to meet your withholding obligations can have serious consequences to the individuals within your company, it is important to devote an appropriate amount of attention, expertise and experience.

For more information or to set up an appointment with a team of MP&S specialists, please contact either **Alysa Forslund, JD** at 212.503.8826 or aforslund@markspaneth.com.