Changing Landscape:

Understanding How Evolving State and Local Tax Issues Affect Your Business

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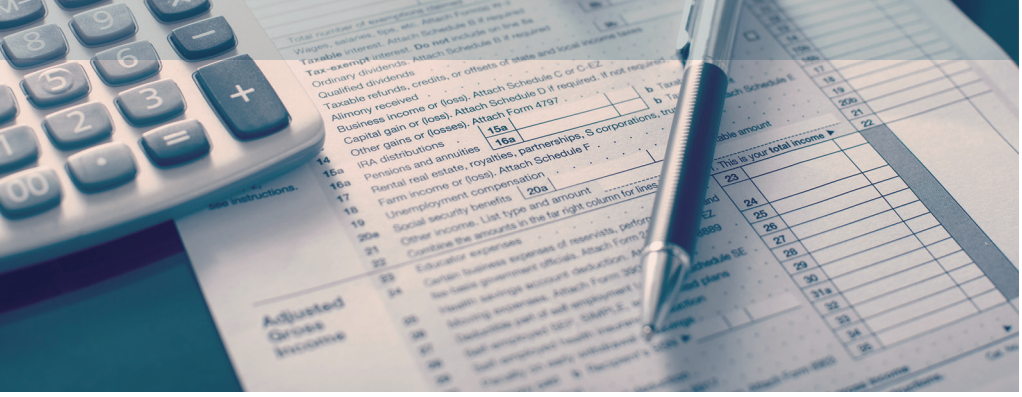

Introduction

Business decisions must be guided, in part, by both real and anticipated expenses. Taxes naturally fall into that category, but over the past few years, expanded tax enactment has occurred at both the local and state levels. This growing burden puts the onus on businesses to stay abreast of any and all change that could affect them. State and local taxes (SALT) can profoundly impact an organization's competitive position. Unlike federal tax, SALT is often based on factors other than income, requiring a deeper understanding of the issues involved.

Our SALT e-book addresses the most common state and local tax issues that affect businesses today.

Contents

CHAPTER 1

The Changing Face of State and Local Taxation

While the overall economy is improving, state finances have been much slower to recover from the loss of funding and programs. States with a need to raise revenue have become more aggressive in enacting tax measures and have intensified the enforcement of these tax laws.

In recent years, SALT has become more prevalent, and that has had a correspondingly larger impact on business decisions and strategies. How does a business stay in compliance while also looking for ways to minimize exposure/risk? It's first helpful to understand what SALT is and what factors define it.

What's Nexus?

It's impossible to discuss SALT without talking about nexus, for it is nexus that creates a state and local filing obligation for a business entity. Simply put, nexus means a business entity has established a direct or representational presence within a particular state or jurisdiction. There are different definitions of nexus, depending on whether it is associated with sales tax or income tax. Both will be covered in more detail in upcoming blogs in this series.

Sales Tax Nexus

Nexus is the determining factor of whether an out-of-state business selling products into a state is liable for collecting sales or use tax on sales into the state. This presence gives the state the right to require a company to pay or collect and remit certain taxes. Say you have an employee travel into a state to call on a customer. In many states, that will create a "sufficient physical presence."

Income Tax Nexus

Income tax nexus is not as straightforward as sales tax nexus. Let's say your business solicits sales in a state for tangible personal property purposes—federal law will protect you from having to pay taxes there. However, the same does not hold true if your business provides a service in various states. Many states have begun adding to the physical presence nexus standard by adopting an economic nexus standard. So, if you have a certain amount of property, payroll and /or sales in a state, the business would be determined to have a nexus.

Because of the ever-changing nexus standards, it is important for a multistate business to take the time each year to determine if nexus has been created with any new states and if so, what steps are required to be in compliance.

The increase in the state and local tax burden can impact an organization's competitive position. As states become more driven to find streams of revenue, it becomes more important than ever for business owners to stay up to speed with changes in compliance requirements and be ever-vigilant of risk.

CHAPTER 2

Income Tax and Sourcing

In the preceding chapter, we examined the need for states to raise revenue through an increasing number of tax measures. We discussed how business entities are required to file taxes when they have established nexus, a direct or representational presence within a particular state or jurisdiction. Now we'll take a closer look at corporate income tax nexus.

Most states impose some type of income-based tax, with the exception of Nebraska, Ohio (commercial activity tax and gross receipts tax), South Dakota, Texas (margin tax based on gross receipts), Washington and Wyoming. A state can only impose an income tax on an entity doing business in its state when nexus has been established. Seems simple enough—but what creates nexus can differ from state to state. Federal law protects businesses that are purely soliciting sales in a state for tangible personal property from being required to comply with a state's income tax laws. However, it does not extend protection to an entity that is soliciting sales in the state for a service or providing a service in the state.

Economic Nexus

Over the past several years, states have been enacting economic nexus standards to pull entities into their state to create a filing requirement, thus creating state revenue.

Generally, these economic standards are a certain dollar amount of property, payroll and/or sales in state. Even though an entity might have economic nexus with a state, public law protection can still be argued in some states if the entity is only soliciting sales of tangible personal property.

State nexus standards will have to be examined to determine if an argument can be made for public law protection. However, keep in mind: Even if you are indeed protected by public law, many states impose a minimum income tax liability. In California, for example, you can claim public law protection, but you would still owe the $800 minimum fee.

Apportionment

Once it is determined that a filing requirement exists, you will need to determine how much of your income was earned as a result of doing business in a state. This calculation is based on

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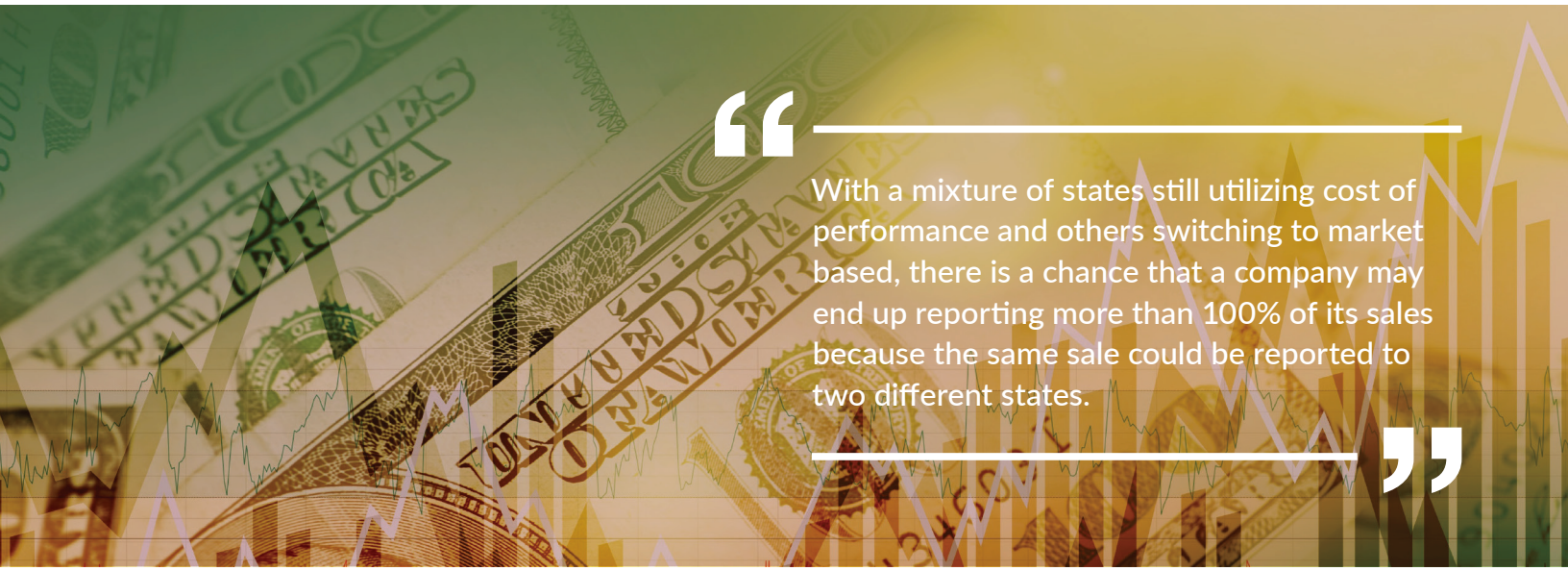
your business apportionment factors by different states. Generally, the apportionment percentage is based on an entity's property, payroll and sales in a state to its property, payroll and sales everywhere.

States weigh these factors differently. For example, some states may double-weight the sales factor where others do not. Many states are also going to a single sales factor method for apportionment. The factors also vary by industry and service; in fact, services are further broken out by two methods: cost of performance (where work is performed) and market-based/economic benefit (where is customer located). Complicated, right? It gets even murkier—states have now begun migrating away from cost of performance by enacting market-based/economic benefit. That means the sale is based on where the customer is located and/or where the customer is receiving the benefit.

With a mixture of states still utilizing cost of performance and others switching to market based, there is a chance that a company may end up reporting more than 100% of its sales because the same sale could be reported to two different states.

For example, if State A is a cost of performance state and the work is performed in State A, all sales would be considered State A sales. But, the customer may actually be located in State B, and if State B utilizes market-based sourcing, the same sale would also be reportable to State B. In this situation, a taxpayer can be paying on more than 100 percent of its income. The opposite can also be true where a sale might not be reported to any state. This would occur if State A were a market-based state and the customer is located in State B, but State B is a cost of performance state. In this case, the sale would not be reported to either state and would be considered a "nowhere sale."

These are only a few of the issues a taxpayer must consider when determining where they must file and under which method they must compute their apportionment.



CHAPTER 3

Sales Tax

Previously, we reviewed income tax in terms of economic nexus and how states view apportionment factors, such as sales, industry and type of service, differently. Now we'll take a look at sales and use tax. Similar to state income tax, a business entity must have nexus with a state before it can be required to collect a state's sales tax. Alaska, Delaware, Montana and Oregon do not have sales tax, though Delaware does have gross receipts tax.

Unlike state income tax, there is no public law protection that applies for sales tax nexus. Once a business has created sales tax nexus with a state, the business must collect that state's sales tax. The nexus threshold for sales tax is significantly lower than state income tax nexus; however, there is still a physical presence requirement before a state can require a business to collect its state's sales tax. Having a sales representative travel into a state is sufficient for nexus to be created.

Generally, all exchanges of tangible personal property are subject to sales tax unless the state provides for an exemption or an exception. Services, on the other hand, are generally exempt unless state statute specifically taxes the service. In Ohio, examples of taxed services include fitness clubs, personal care services (e.g., hair, nails, massage), and lawn and snow services.

Generally, all exchanges of tangible personal property are subject to sales tax unless the state provides for an exemption or an exception.

Once nexus is established, it is important to examine state statute to determine if the product being sold or the service an entity is providing is taxable in the state. Exemptions/exceptions will differ by state. Some states may exempt manufacturing equipment and other states might tax the purchase of such equipment. In addition to exempted products and services, some entities are exempt, and in those instances, a business would not be required to charge sales tax. An example of an entity that might be exempt from state sales tax is a nonprofit organization. Analysis will also have to be conducted to determine what sales tax rate is required to be charged on the various transactions.

Generally, most states provide for an exemption from sales tax if the product or service being purchased will be resold. Take note: If the purchaser is claiming a resale exemption, it is important for the seller to secure an exemption certificate from the purchaser. This documentation is required to support the exemption if a state conducts a sales tax audit of the seller.

Use Tax

All states that impose a sales tax also impose a use tax. Use tax, as the name indicates, is generally due on the purchase of items used in a business. Any individual who purchases an item in which sales tax was not paid must pay use tax on the item. Examples would include items purchased over the internet and those purchased for use in one state but purchased from a vendor located in another state. Any exemptions/exceptions that a state statute provides for sales tax would also apply for determination of any use tax due.

There still needs to be a connection with the state before remittance of use tax is required. Generally, this would be established by having a location in the state, such as an office, plant and/or a warehouse.

States are attempting to expand their sales tax reach by enacting affiliated nexus and click through nexus.

CHAPTER 4

How to Clear Up Past State Exposure

Once you have determined you have a past state tax exposure, how do you handle this issue in the most efficient and effective manner? The issue could be delinquent state income tax or sales/use tax, but the options available for handling are the same.

Voluntary Disclosure Agreement

The most common method for handling past state tax exposure is a voluntary disclosure agreement (VDA). Generally, every state that imposes a state income tax and/or sales/use tax has a VDA available. Some states might call it by a different name – voluntary compliance agreement, managed audit – but they more or less function alike. To qualify for a VDA, the taxpayer cannot have been previously contacted by the state for noncompliance with its tax laws. There are other requirements before a taxpayer can participate in a VDA, but this is generally the most common requirement that will kick taxpayers out of a VDA.

Under a VDA, the company will approach the state in an anonymous request to enter into a VDA. It is highly recommended that a third party handle the VDA so that the state does not know who the taxpayer is. There are a few states that do not permit an anonymous VDA, but it is still highly recommended to utilize a third party to manage the VDA process and interact with the state.

Also, under a VDA, a shorter look-back period is enforced. For example, you might have been operating in a state for 10 years when it is determined that you should have been filing state income tax returns there. Under a VDA you will not have to go back all 10 years; often the lookback period is only three or four years. The shorter lookback period will apply whether it is a VDA for sales tax or state income tax.

The only time a shorter lookback period will not apply under a VDA is if the taxpayer collected sales tax and did not remit the tax collected. A VDA for sales tax collected and not remitted will require the taxpayer to go back to the first date that sales tax was collected. Generally, if the VDA is for sales tax collected but not remitted, penalties will still be imposed in addition to tax and interest.

As part of a VDA, the state will make sure that the taxpayer is in compliance with all taxes imposed by that state. For example, if you approach a state for a sales tax VDA, it will make sure that you also do not need a state income tax VDA.

The final step of a VDA is to file all back returns as required by the VDA agreement. The taxpayer that comes forward under a VDA must also agree to register with the state and continue to comply with state tax laws on a go-forward basis. As part of the VDA, the state will indicate that all returns filed as part of a VDA are subject to audit.

Amnesty

Another option to address past tax exposure is amnesty. States do not always offer amnesty; it must be adopted by the state legislature and generally is only offered for a certain period of time. Generally under amnesty, penalties are abated and you will only be subject to tax due and interest. Some states might also abate half of the interest that might normally be assessed.

If a taxpayer is coming forward under amnesty to fix past tax issues, it is not done on an anonymous basis—the taxpayer is known to the state. Often under amnesty a state might notify taxpayers who have delinquent filings or other tax issues, informing them of amnesty so that they can come forward and address all delinquencies. Generally, the only time a taxpayer might not be eligible to participate in a state's amnesty program is if the taxpayer has previously participated in an amnesty program offered by that state.

The most significant difference between amnesty and a VDA is the fact that the taxpayer coming forward is not anonymous if past filings are done through amnesty. These are the best options available for a taxpayer to address a taxpayer's past exposures.

CHAPTER 5

The Changing Landscape of State and Local Taxes

Compliance

When it comes to tax compliance, states have increasingly gained in sophistication over the years. Information sharing has grown both within and among states.

When conducting an audit of a taxpayer, many states will request the completion of a nexus questionnaire that will be shared with the different states that have entered into a sharing agreement. For example, Ohio is a participant in the Great Lakes nexus questionnaire. This questionnaire asks a taxpayer about their operations in the participating states. Once the questionnaire is completed by a taxpayer under audit, the questionnaire is shared with the other states. Also, some states' revenues have been dramatically impacted as a result of the Great Recession, which has caused them to become more aggressive in pulling taxpayers into their states.

State Income Tax

As discussed in a previous chapter, the landscape is dramatically changing for state income tax. One of the changes for taxpayers is the change in the sales situs for revenue generated from providing a service. The change being enacted by the states is using these sales based on the economic benefit, or where the customer is receiving the benefit of the service.

Work for a customer might all be performed in Ohio, although that customer is located in California. Still, since California determines sales based on the benefit received, the sale would be a California sale. If the work is performed in state A, a cost of performance state, the sale would also be sale for that state; thereby the sale would be double counted.

Another aspect of state income tax that has been changing over the last several years is the method for determining how much of a taxpayer's income should be taxed in a particular state. As previously discussed, states are migrating toward a single sales factor to determine what amount of a taxpayer's business should be taxed in the state.

The last significant change in the state income tax arena is the nexus standards imposed by different states. Many states are enacting an economic nexus standard. That means if a taxpayer has sufficient property, payroll and/or sales in a state, the taxpayer is required to comply with state law and file an income tax return.

The most common economic nexus standard is based on a certain amount of property, payroll and sales in a state—this often is at least $25,000

of property or payroll in a state, or $250,000 of sales in a state. In those cases, the state will create nexus and require a taxpayer to file state income tax returns. Some states have also just enacted a standard that addresses sales in state. For example, California's economic nexus standard starts with $500,000 in sales, which is indexed each year based on inflation.

Sales Tax

Sales tax compliance has also changed dramatically, with the majority of changes involving internet activity. States will utilize the internet to determine if businesses are operating within their state boundaries. States have also been very active in enacting legislation to tax sales over the internet. There is still federal legislation (the Marketplace Fairness Act) pending to tax internet sales, but until this legislation can be enacted, states are taking other steps to address this growing issue.

The legislation that states have enacted is generally known as click-through nexus. Simply put, this is the requirement by a state requiring an out-of-state vendor to collect sales tax if the taxpayer compensates residents of the state for sales made via links on their website. This type of operation is very common with the individuals utilizing the internet for many different activities.

Often, along with the "click through nexus" standard, there is a certain dollar amount of sales that a taxpayer must have in state to impose "click through nexus."

Another step states are taking to generate additional sales tax revenue is affiliate nexus standards. Similar to click-through nexus, affiliated nexus is designed to pull remote sellers into their state for sales tax compliance. If an entity has nexus with a state for sales tax purposes, all related entities will also be deemed to have sales tax nexus, and a requirement to collect that states sales tax.

What to Do

With states constantly changing their nexus standards, it is important for all multistate businesses to monitor their activities in different states to make sure they are in compliance with varying state tax laws. It is important for a business to know what states they are operating in, and how they operate in those states. It is highly recommended that a business undergo some sort of nexus analysis each year to determine if additional filings need to be completed.

CHAPTER 6

Wayfair Update: Location Does Not Prevent Taxation

While the collection of sales taxes has always been a contentious issue, some elements of collection requirements were much clearer in the past due to federal court precedents than they will be going forward. Before the widespread use of the internet, any entity engaged in significant business in a state was typically only able to do so by having a physical location in state. Historically, if someone wanted to purchase clothes, see a movie, or partake in most other commerce activities they were only able to do so by visiting a brick and mortar location. A strong national post system made some interstate sales easier through mail order catalogues, however, retail sales at brick and mortar locations were more common. It is now possible to make purchases from retailers headquartered across various states and sometimes even national borders faster than ever. The increasing popularity of online retail has created a legal and pragmatic conundrum for state taxing authorities. As physical retail outlets dwindle it has left a sales and use tax void within local government that states are struggling to fill. A recent supreme court ruling to overturn a former federal court precedent is expected to drive major changes through state legislation with regard to out of state retailers' requirements to collect and remit sales taxes.

Origins

It was established in the National Bellas Hess, Inc. v. Illinois Dept' of Revenue (1967) case that a physical presence is required for a state to impose tax collection and payment upon sellers. Decades later, the issue was challenged again in the case Quill Corp. v. North Dakota (1992). Quill is a corporation that sells office equipment and supplies to customers in states outside of its state of incorporation, Delaware. At the time of the case, Quill reported significant revenue generated from selling to clients in North Dakota. The state attempted to compel Quill to collect and pay state sales taxes, arguing that floppy disks containing Quill's software constituted a physical presence in the state. The Supreme Court rejected the argument, citing P.L. 86-272, and reinforcing the physical presence standard. Its ruling has essentially provided online retailers precedent to take the position that conducting business in another state does not create filing requirements provided no physical presence exists. One distinction the Supreme Court made is that it removed the Due Process Clause basis for a physical requirement. The Commerce Clause was deemed pertinent in this argument. The reasoning is that only Congress has the power to establish interstate laws and regulations. While the Supreme

Court ruled in Quill's favor, the opinion left room for interpretation and for states to bring forth similar cases to challenge the issue of collecting sales tax from online transactions.

Ramifications

As brick-and-mortar stores become less prominent, online retailers continue to flourish. One of the major sources of revenue for many state governments is sales and use tax. According to the 2018 1st Quarter US Census Bureau Report, the estimate of US retail e-commerce sales is $123.7 billion (US Census). Some states such as Michigan estimate they were not able to collect $290 million in one fiscal year alone. The loss in potential revenue has been compounded by a growing industry that did not give regard to sales tax collection and remittance relying on the precedent set by the Quill verdict. There are a few states that do not impose sales taxes, however, those who do typically collect tax rates between five and nine percent. A report by the Government Accountability Office found that approximately $8 billion could have been collected from online sales if online retailers collected sales tax in all states business was transacted within (US GOA). The loss is an even greater detriment to states such as Florida, Texas, and South Dakota that do not charge income tax because they rely more heavily on the revenue from sales and use tax collections.

As with most situations in life, there are those advantaged and disadvantaged by circumstances. The parties who benefitted from avoiding online sales tax were consumers and online retailers. Retail customers typically make buying decisions based on costs and ease of access. Imposing tax collection requirements on this popular method of trade will increase the cost of many online purchases, which may help to level the playing field between the online and the brick and mortar retailers.

Local businesses and taxing authorities argued that they were disadvantaged by the tax collection structure. Commerce was being conducted in states, up to millions of dollars in some cases, but states were not able to realize any of the potential revenue. With reduced funding many state and local governments were forced to to adjust budgets and discontinue services in response to decreasing revenue. Local businesses with a physical location in state are often not able to offer the same low price as online providers due to overhead costs, however, the additional layer of cost of state and local sales tax makes it even more difficult to price products competitively. Small, local businesses which are not large enough to conduct national business have trouble competing in local markets due to the saturation of online retailers readily available.

South Dakota v. Wayfair, Inc.

The sales tax collection debate resurfaced in the case of South Dakota v. Wayfair, Inc. Compliance with sales tax regulation was so low that the state estimated it lost $50 million to potential sales-and-use-tax revenue from out of state vendors conducting business in the state but not collecting sales tax. This was a significant loss because sales tax revenue was the majority of the state's funding. To counteract this loss, the state instituted a law in March 2016, Senate Bill 106, that required sellers who sold "tangible personal property" with total sales exceeding $100,000 annually to begin collecting state sales tax. The act was intentionally designed to challenge the previous Quill court case decision. South Dakota tax authorities hoped the interstate online tax debate would be reevaluated. Several out of state retailers refused to comply with the new act, including Overstock, Newegg, and Wayfair.

When the case was brought before the South Dakota Sixth Judicial Circuit in March 2017, the retailers were granted a Motion for Summary Judgement in their favor since the previous Quill precedent was still in effect. The state then appealed the decision to the South Dakota Supreme Court. At the South Dakota Supreme Court trial, the State conceded its case, and requested that the Court affirm the lower courts decisions and provide support for their cert

petition to the Supreme Court. The quick ruling allowed South Dakota to take the issue to the Supreme Court in a timely manner.

The retailers defense hinged on a couple of principals and concerns. One being that there are more taxing authorities than in the past, approximately 12,000 now compared to 6,000 in the 1990s. Having to comply with all levels of tax agencies would create an undue burden on out-of-state retailers. Secondly, they asked the court to give serious weight to Stare Decisis. They asserted that the matter of interstate online commerce has already been settled and urged the Court to stand by their previous decision. Lastly, one of their concerns was that states would begin to discriminate against online retailers. State and local governments could find it more favorable among their constituents to impose the onerous task of collecting and remitting sales tax to external vendors than attempting to collect from citizens. Politicians are accountable to their voters and bear no responsibility to third parties who do not hold voting rights.

The Supreme Court ruled to overturn the previous Quill decision, citing that changing economic and technological advances have created a different legal and social environment. Their reasoning is that lacking a physical presence is not enough to avoid collecting sales tax, and that the past law interpretation created market distortions because it "judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a state's residents." Furthermore, they noted that the Quill interpretation discouraged interstate commerce because it gave an incentive to companies to avoid owning any physical locations in other states as a way to avoid taxation. The decision allows for purchases from out-of-state vendors to be taxed, regardless of whether or not they have a physical presence in the state.

Time will tell how the Supreme Court's decision will be interpreted and handled going forward. Some businesses argue that it is unduly burdensome to calculate and remit sales tax for all the states business is conducted within. Another concern is enforcement, since the volume of online sales is so large it is likely some vendors will continue to avoid collection and not comply with state rules and regulations. Lastly, some argue that Congress should be the main authority to decide how online tax collection should be handled. There is proposed legislation to create a national standard such as the Remote Transaction Parity Act, also known as the Marketplace Fairness act. Such proposals have been criticized by accounting agencies such as the American Institute of Certified Public Accountants, stating that they believe its adoption would complicate interstate commerce. One thing is certain, if your company is conducting business in other states and has not reviewed compliance requirements, now is the time to review interstate commerce activities and make determinations on the company's tax reporting, collection and remittance obligations.

Conclusion

We hope you have found this e-book helpful in your tax planning. Using a comprehensive approach, our SALT professionals gain an understanding of your business needs and employ a combination of strategies specifically tailored to your situations. The results help you achieve tax and non-tax benefits that make a difference in your competitive position.

The EFPR Group SALT team works across state lines to provide clients with the tax guidance they need in areas including income and franchise tax, indirect tax, and credits and incentives.

For questions about the effect of SALT on your business or if you need more information on the latest tax updates or EFPR's State and Local Tax Advisory services, email SALT@EFPRgroup.com or call **585.340.5129**.

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