

HLB State Tax Update



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CPAs & BUSINESS ADVISORS



Overview

- State Nexus Expansion Efforts
- Major Audit Issues
- Apportionment Best Practices
- Unclaimed Property





Connection With a State

- There is tremendous confusion among taxpayers
- Most common presumption for taxpayers is nexus only occurs with employee residing in a state or actual building in state
- This has never really been the case
- Nexus does vary based on whether we are talking about income tax or sales tax



Sales Tax Nexus

- US Supreme Court has held substantial presence is required to impose the burden of collecting and filing sales tax
 - ✓ *Quill v. North Dakota*, 504 U.S. 298 (1992)
- Substantial presence = physical presence
- There is a de minimis component but this is generally undefined (for example – MN allows 24 hours of physical presence)

Sales Tax - Ecommerce

- States are losing revenue to ecommerce retailers with no physical presence
- Beginning with NY other states have adopted Amazon rule-
 - \$10,000 sales into the state and
 - use another's website and pay a commission
- But it wasn't enough
- Other retailers are also joining the fight on the side of states to go after online retailers



Colorado Tax Reporting Requirement

- In 2010, Colorado required out-of-state sellers who did not have nexus to provide the CO DOR with information on customers. Retailers were required to:
 - Notify CO customers that sales tax was not collected and use tax should be paid (\$5) ;
 - Provide each CO customer with annual statement of purchases and a reminder to pay use tax (\$10);
 - Provide the DOR with a list of each customer including the customer's name, address and total amount of purchases (\$10).

Now Where Do We Stand?

- Direct Marketing Association (DMA) challenged CO in court.
- An injunction was granted but the appeals court ruled the Tax Injunction Act barred federal courts from hearing the challenge. This was reversed by the U.S. Supreme Court in March 2015.
 - Justice Kennedy in a concurring opinion stated maybe it was time to reconsider the Court's holding in *Quill*.



Alabama Nexus

- Beginning January 1, 2016 Alabama enacted a new economic nexus requirement for sales tax.
- Out-of-state sellers with no physical presence in the state, must collect sales tax if they make \$250,000 sales into AL and:
 - ✓ Maintains any space including storage or warehouse space;
 - ✓ Employs any representative in the state;
 - ✓ Solicits with a broadcaster or publisher
 - ✓ Solicits orders by mail;
 - ✓ Distributes catalogs or other advertising matter in AL.



Tennessee

- Any dealer meeting the following thresholds must register with TN by March 1, 2017 and collect and remit tax beginning July 1, 2017
- Substantial nexus is established when out of state dealer –
 - Engages in regular or systematic solicitation of consumers in TN by any means and
 - Makes sales exceeding \$500,000 in a 12 month period



South Dakota

- Effective May 1, 2016 South Dakota instituted an economic nexus rule for sales tax.
- An out-of-state retailer with no physical presence but sales thresholds of \$200,000 (annually) or 200 separate transactions will have created nexus.



Income tax nexus

- Generally based on business activity or business presence in a state.
- This is true for franchise or privilege taxes.
- Minnesota – “Anyone doing business in the state.”



Economic nexus

- A number of states of created a bright line economic standard
- Generally use an old MTC suggestion
 - \$50,000 of property or greater
 - \$50,000 of payroll or greater
 - \$500,000 of sales or greater
 - Or if any of these factors represents 25% or more of the company's total (for example 25% or more of property) (CA, CO, CT, MI, NY, OH, TN, VA, WA)



Common Nexus Issues

- Businesses presume nexus is only through resident in-state employee or property
- Don't consider a sales person visiting creates nexus this includes third party sales representatives
- Trade shows
- Warranty work
- Advertising
- Delivery vehicles
- Telecommuting employee
- Promotions



Public Law 86-272

- Provides protection paying income taxes if only presence is-
 - From solicitation activity
 - For sales of tangible personal property
 - No post solicitation activity
 - Sale is approved outside of the state



Remember

- Only applies to income tax – not franchise tax, B&O, gross margin tax, privilege taxes, etc. (TX, OH, WA)
- PL 86-272 does not eliminate a filing requirement – some states still require a filing and for the taxpayer to state 86-272 protection applies
- You might have 86-272 protection but in CA you still need to pay the minimum fee
- Questions often arise on what is a sale of tangible personal property or a service?



Major Audit Issues

“He's spending a year dead for tax reasons.”

— Douglas Adams,

The Hitchhiker's Guide to the Galaxy



Common Sales Tax Audit Issues

Sales side issues-

- Not every state is the same! Don't presume an exemption or the taxability will be the same in every state.
- Not charging a customer sales tax
(generally based on the assumption there is no nexus)
- Not having exemption certificates
(even when nexus has been established)
- Taxability decisions are wrong
- Not collecting local taxes
- Selling to exempt entities



Common Audit Issues

Use tax issues-

- No credit card receipts
- Software
- Local taxes
- Fixed assets were not taxed
- Internet purchases
- Taking products from inventory
- Bringing in supplies, equipment, etc. from out of state



Exemption Certificates

- The failure to obtain or maintain the proper exemption certificates is one of the largest liabilities on a sales tax audit.
- When selling tangible personal property all sales must be presumed to be taxable
- The purchaser must establish the exemption through a valid certificate

Troubling Trends in Audits

- Nexus
- Rejection of Exemption Certificates
- Strict Record Keeping Requirements
- Statistical Audits
- Use of Subpoenas
- Statute of Limitations
- Access to Software
- Confusion in the Statutes



Audit Activity

- OK has not been auditing taxpayers in recent years. Just hired 50 new sales tax auditors
- All states are looking at more efficient audits to increase the ROI



Oklahoma

Total Sales	\$XXXX
Less – Exempt Sales	<u>(\$XXXX)</u>
Taxable Sales	\$XXXX

Provide proof of all taxable sales for the past month! Exemption certificates, invoices detailing product was not taxable. Proof of out-of-state transactions.....



Common Income Tax Audit Issues

- Residency vs. Non-residency
- Not filing believe nexus has not been established
- State conformity to Federal
- NOLs
- Apportionment
- Consolidated, Unitary or Separate filings
- Business/Nonbusiness income
- Minimum fees

Apportionment

“He's spending a year dead for tax reasons.”
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»»» Apportionment





Sourcing

- Apportionment sourcing for TPP is where the property is shipped or delivered
- Rules may differ when it comes to services
 - Cost of Performance
 - Pro-rata
 - All or Nothing
 - Market Based



Sourcing of Services

- Under market-based approach, services are assigned based on the following methods:
 - State where services or benefit of services are received or delivered
 - State where the customer is billed
 - State where customer's marketplace is located
- Specific rules for market-based sourcing can vary widely from state to state and, within a particular state, may vary by industry



Cost of Performance

- Applies to sales other than TPP
- General rule-
 - If the income producing activity is performed in more than one state, sales are sourced to the state with the greatest income producing activity.



Market Based

- Sales are sourced based on where customer benefits from the service
- The shift is to market based sourcing (19 states)
 - AL, CA, CT, GA, IL, IA, LA, ME, MD, MA, MI, MN, NE, NY, OH, OK, RI, TN, UT, WI, WA
- The shift has also increased the shift to single-factor sales apportionment

Unclaimed Property



What is unclaimed property?

- A dormant financial asset owed to a business or individual
- If Holder cannot locate property owner, property must be turned over to the State
- State holds assets for owners and honors proper claims by the owners

Examples of Unclaimed Property

Uncashed checks

Credit memos

Dormant savings
accounts/retirement
accounts

Stocks, bonds, &
dividends

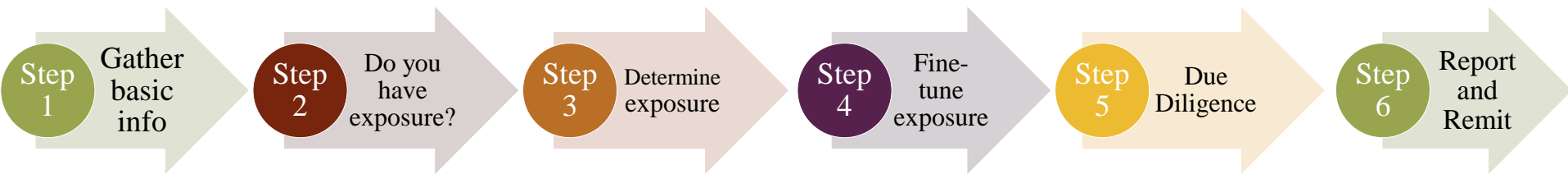
Life insurance
proceeds

Customer
overpayments

Unused Rebates

Gift certificates

How to Report Unclaimed Property





Why are we talking about this today?

- National compliance relatively low
- Uneducated holders
- States increasing enforcement efforts
- States contracting with third party contract auditors
- Failure to comply can be devastating
- Typical look back period is 10-20 years or further



Delaware

- Supreme Court determined rules for sourcing property to the proper state
- Delaware benefits by the second sourcing rule – if property owner address is not known – then state of incorporation
- Delaware recently extrapolated audits back to 1981. However, in July 2015 the state passed a law limiting the lookback to 22 years.
- Penalties of 5% per month up to maximum of 25%
- Delaware maximizes assessments by presuming all unclaimed property belongs to the state
- Third largest revenue source for the state at over \$500 million per year



How Bad Can It Be?

Temple Inland v. Cook

- A mere \$147.30 of unclaimed property found by an auditor
- Extrapolated back to 1981, turns into a \$2 million assessment.
- Appeal only reduced amount to \$1.4 million.
- Litigation continues



Unclaimed Property is Worse Than a Tax

Rights	Tax	Unclaimed Property
Statute of limitations	3-4 years	None
Voluntary Disclosure Agreement	3-4 years	10-20 years
Third Party Audits	No	Yes
Finders Fee	No	12%
Administrative Appeals	Yes	No
Multistate audit	Rare	Typical
Deduction/Credit	Yes	No
Nexus	Yes	No
Record retention	4-7 years	A long time

»»» Consider for a moment....





The code expires

Site #: 0000000009735747

Shift Number 2

Sequence Number 15449

APPROVED 553573

* * * * *

Your car wash

code is 43360

Expires 4/08/2016

* * * * *



Is a car wash code unclaimed property?

- Does the car wash code meet the elements of abandoned property?
 - Intangible financial asset
 - Fixed and legal obligation
 - Dormant
 - Unable to locate owner



Considerations

- Definitions are not the same in each state
- Dormancy periods vary state by state
- Owner can recover some expenses in a few states
- Reduce property amounts through legally imposed service fees
- Business to Business exemptions (IL, IA, IN, OH, MI, WI) – must be examined closely
- Laws have changed over the look back periods and these changes must be accounted for year-by-year
- Property may be exempt in one state but state of incorporation rules may throw back exempt property and force it to be remitted



Advice

- Don't become lulled into believing this is a simple process.
- Beyond failing to report – failing to report correctly can be even more costly.
- Clients face conflicting and changing laws.



In Conclusion

“Let me tell you how it will be
There's one for you, nineteen for me
Cos I'm the taxman, yeah, I'm the taxman”

- From The Beatles 1966 song “Taxman”

Questions?



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Thank You!



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