2010 IHA GOVERNMENT AFFAIRS COMMITTEE

State & Local Tax Presentation

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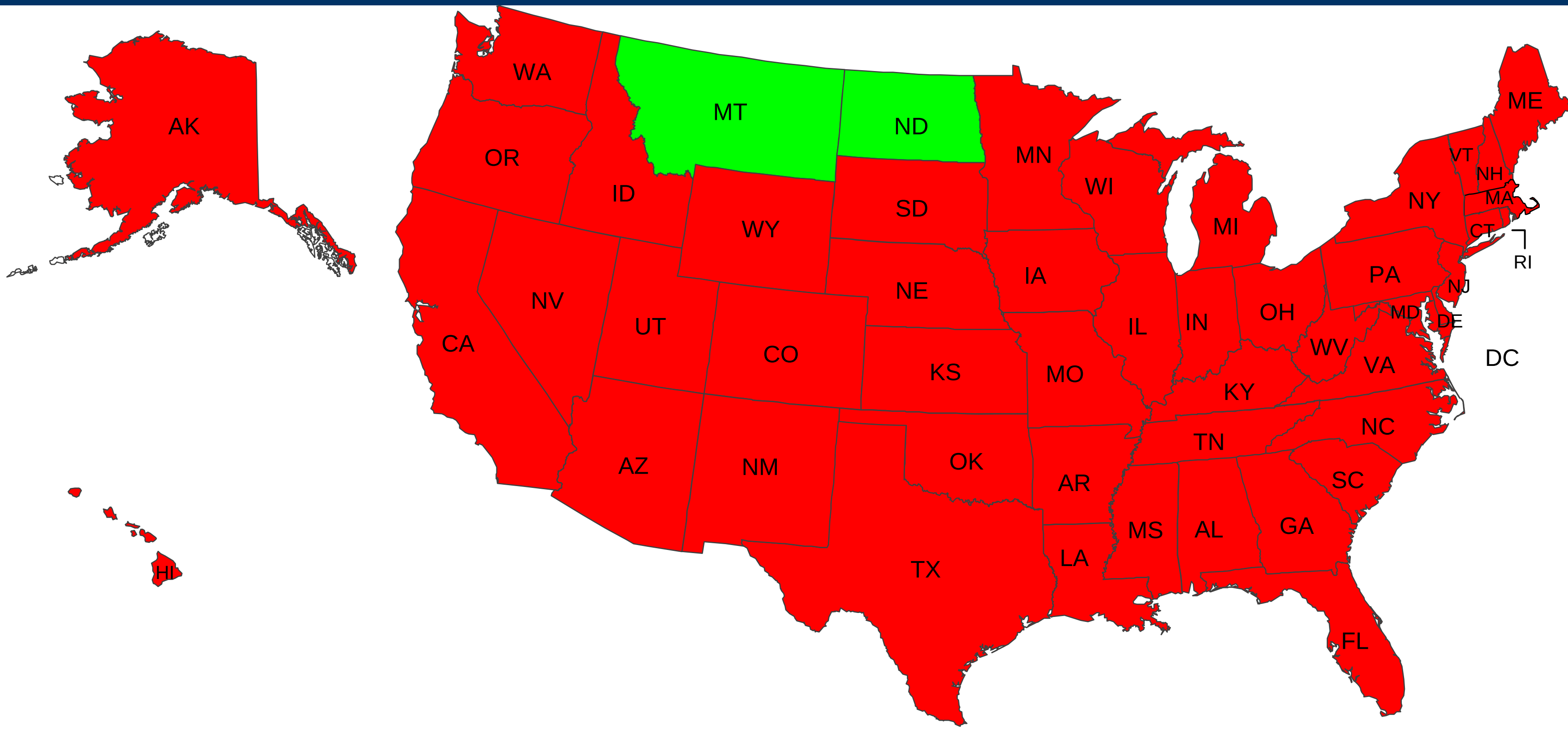
June 16, 2010

Agenda

- State of the States
- Overview of Nexus
- Federal Law
- States' Doing Business Standards
- Sales & Use Tax Nexus Creating Activities
- Franchise Tax Nexus Creating Activities
- Income Tax Nexus Creating Activities
- Voluntary Disclosure & Amnesty
- Questions

State of the States

48 States With Budget Shortfalls



States without A FY2010 Shortfall

States with a FY2010 Shortfall

Examples of State Budget Shortfalls – FY 2010

- **California – $52.1B**
- **Colorado – $1.6B**
- **Florida – $6.0B**
- **Illinois – $14.3B**
- **Kansas – $1.8B**
- **Massachusetts – $5.6B**
- **Missouri – $1.5B**
- **New York – $21.0B**
- **Ohio – $3.6B**
- **Pennsylvania – $5.2B**
- **Rhode Island – $990M**
- **West Virginia – $304M**

**Total budget shortfalls are the sum of FY2010 before budget adoption plus FY2010 mid-year gap. Source: McNichol & Johnson, *Recession Continues to Batter State Budgets; State Responses Could Slow Recovery*, Center on Budget and Policy Priorities (Feb. 25, 2010).

Overview of Nexus

Overview of Nexus

One of the most difficult steps in complying with state tax laws, is determining in which state a taxpayer has nexus.

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This is the first question that should be addressed when dealing with any state tax question.

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Nexus thresholds vary based on the type of tax involved: franchise tax, sales and use tax, and income tax.

Overview of Nexus

Nexus Defined

Nexus refers to the degree of contact an out of state taxpayer must have with a state in order for the state to assert tax authority over the out of state taxpayer (i.e., require the taxpayer to pay or collect sales and use taxes, or pay franchise or income taxes).

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Nexus is an all or nothing concept. A company either has nexus or it does not. The activity which creates nexus does not have to be related to the activity that is taxed by the state.

Overview of Nexus

Nexus Standards

Nexus standards and definitions are continually evolving through analysis and interpretation of the following:

- Constitutional Guidelines
- Case Law
- Federal Law
- States' Doing Business Statutes

Federal Law

Federal Law

<u>Public Law 86-272 (15 USCS § 381)</u>

In 1959, Congress enacted P.L. 86-272. P.L. 86-272 limits states' ability to impose a net income tax upon taxpayers in certain circumstances.

States are precluded from imposing an income tax upon a person, "if the only business activities within such State by or on behalf of such person during such taxable year are either, or both of the following:

1. The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
2. The solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)."

Federal Law

<u>Protected Activities</u>

Solicitation of Sales

- Advertising
- Soliciting sales

Ancillary to Solicitation

- Carrying samples
- Setting up display racks
- Computer or car provided to salesperson
- Passing orders & complaints to home office
- Checking customer inventory
- Employee home office

<u>Unprotected Activities</u>

- Maintaining an office (other than a home office)
- Owning or leasing property in a state
- Performing services, including installation, repairs or maintenance
- Conducting training
- Collecting current or delinquent accounts
- Investigating creditworthiness
- Approving or accepting orders
- Resolving customer complaints
- Delivery of goods in company owned vehicles (pursuant to National Private Truck Council Cases)

States' Doing Business Standards

States’ Doing Business Standards

MTC 95-1

In 1995, the Multistate Tax Commission issued Nexus Program Bulleting 95-1 which addressed the sales and use tax and income tax nexus consequences of companies selling computers through direct marketing and offering repair services in the customer’s state through the seller’s warranty.

The overriding principle developed through this Bulletin is that in the instance where warranty or service work is performed by a third party on behalf of an out of state taxpayer; the performance of such services is sufficient to create nexus for the out of state taxpayer in the state.

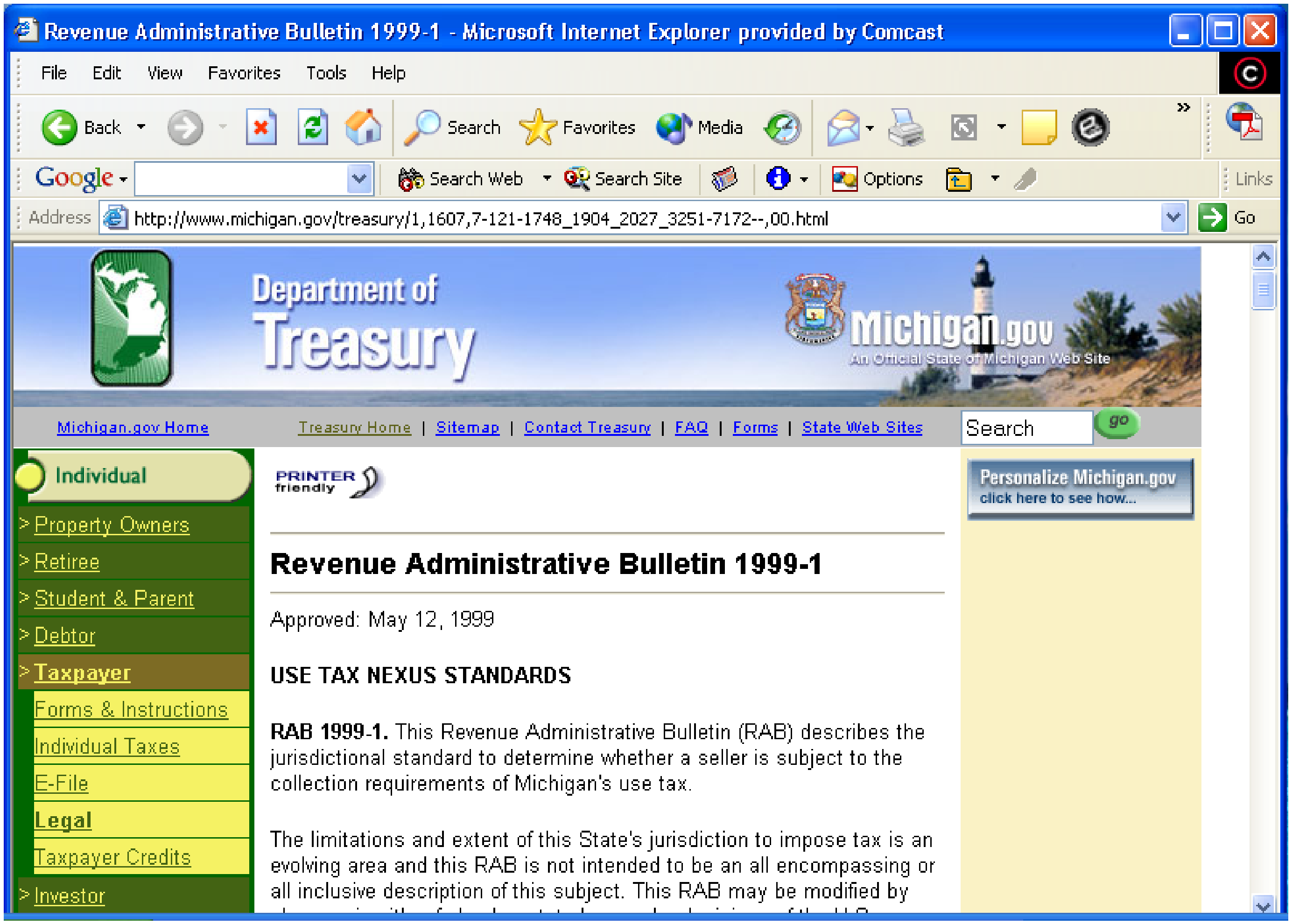
States’ Doing Business Standards

Michigan

On May 12, 1999, Michigan Treasury issued RAB 99-1, which establishes the use tax nexus standards. RAB 99-1 states that an out-of-state seller is subject to Michigan’s use tax collection responsibility when it engages in any of the following activities:

- It has one or more employees resident or temporarily present in Michigan engaging in any activity other than those described in paragraph 7 of RAB 99-1. An employee temporarily present in Michigan for two days will create nexus.
- It owns, rents, leases, maintains, or has the right to use and uses tangible personal or real property that is permanently or temporarily physically located in Michigan.
- Its employees own, rent, lease, use, or maintain an office or other place of business in Michigan.
- It has goods delivered to Michigan in vehicles the out-of-state seller owns, rents, leases, uses, or maintains or has goods delivered by a related party acting as a representative of the out-of-state seller.

States' Doing Business Standards



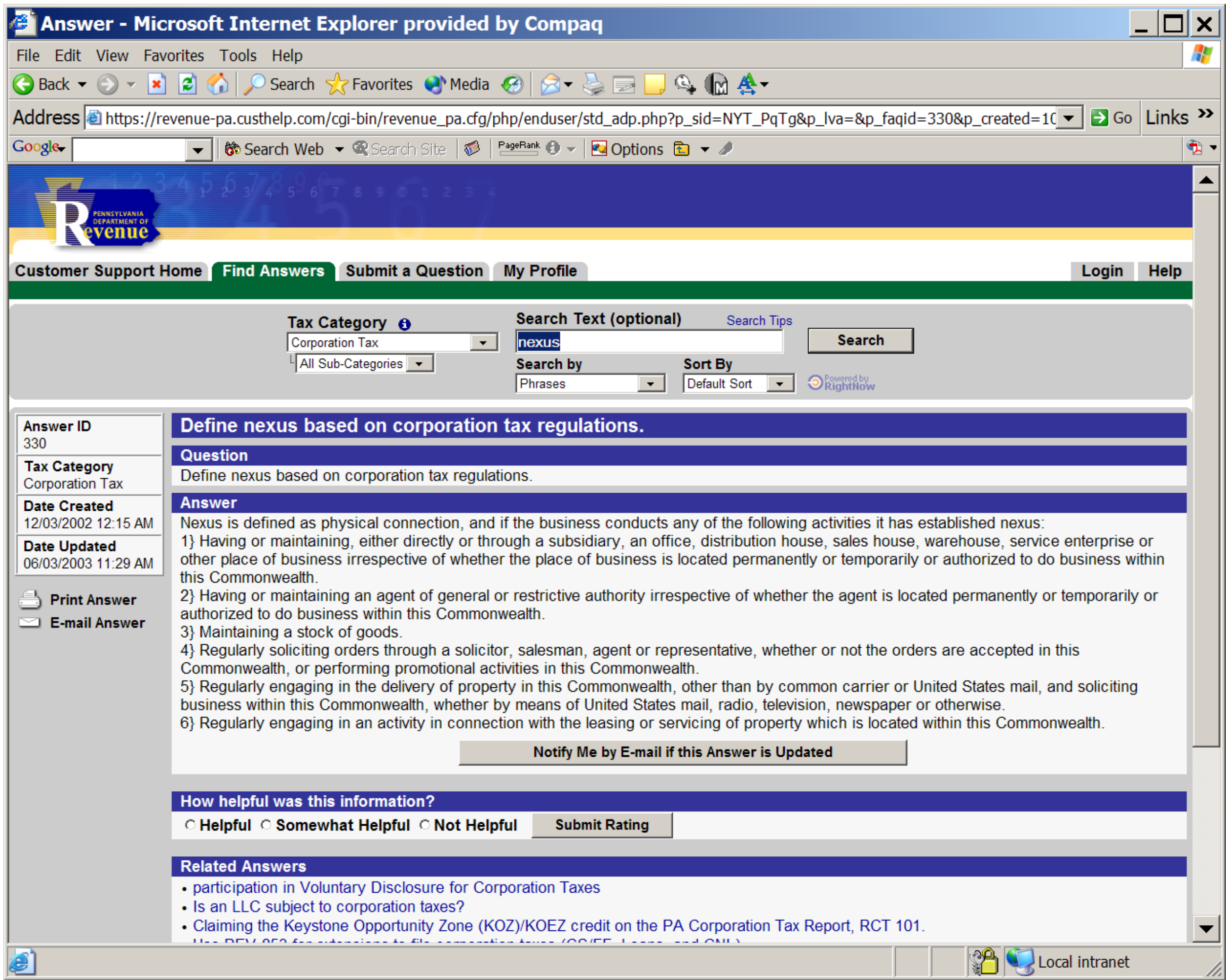
States’ Doing Business Standards

Pennsylvania

Pennsylvania has interpreted nexus based on corporate tax regulations. Nexus is defined as physical connection, and if the business conducts any of the following activities it has established nexus:

- Having or maintaining, either directly or through a subsidiary, an office, distribution house, sales house, warehouse, service enterprise or other place of business irrespective of whether the place of business is located permanently or temporarily or authorized to do business within this Commonwealth.
- Having or maintaining an agent of general or restrictive authority irrespective of whether the agent is located permanently or temporarily or authorized to do business within this Commonwealth.
- Maintaining a stock of goods.
- Regularly soliciting orders through a solicitor, salesman, agent or representative, whether or not the orders are accepted in this Commonwealth, or performing promotional activities in this Commonwealth.
- Regularly engaging in the delivery of property in this Commonwealth, other than by common carrier or United States mail, and soliciting business within this Commonwealth, whether by means of United States mail, radio, television, newspaper or otherwise.
- Regularly engaging in an activity in connection with the leasing or servicing of property which is located within this Commonwealth.

States' Doing Business Standards



States' Doing Business Standards

Philadelphia

Philadelphia Regulation 103 provides that for purposes of the business privilege tax, effective July 1, 1998 no more than an "active presence" is required to constitute "doing business" in Philadelphia. Following is a sample list of business activities that will subject an out-of-Philadelphia business to the Philadelphia Business Privilege Tax when it engages in any one of such activities.

1. An out-of-Philadelphia business will be deemed to have created "nexus" if it regularly and systematically conducts business activity in Philadelphia through employees, agents, representatives, independent contractors, brokers or others acting on its behalf, whether or not these individuals or organizations reside in Philadelphia;

a. Regular and systematic business activity exists if 10 or more days of business activity occurs in Philadelphia on an annual ("annual" meaning a 12 month taxable year) basis;

b. Regular and systematic business activity may exist, depending on the facts and circumstances of the taxpayer, if less than 10 days of business activity occur in Philadelphia on an annual ("annual" meaning a 12 month taxable year) basis.

Sales & Use Tax Nexus Creating Activities

Sales & Use Tax Nexus Creating Activities

Having sales in a state does not create nexus. Nexus requires some form of physical presence, which can be any of the following:

- Owning or leasing property in a state.
- Having employees based in a state.
- Delivering goods in a company owned or leased vehicle.
- Soliciting sales through the use of an employee, dependant or independent contractor.
- Installing or repairing property in a state through the use of an employee, dependant or independent contractor.
- Conducting training sessions in a state.
- Attending trade shows in a state (although some states specifically exempt attendance at trade shows).

Sales & Use Tax Nexus Creating Activities

<u>Owning or leasing property in a state.</u>

Owning or leasing property in a state creates a physical presence for a taxpayer. Property owned or leased could include a sales office, computer equipment, vehicles, inventory on consignment, etc.

<u>Having employees based in a state.</u>

Having an employee based in a state creates a physical presence for a taxpayer. The employee can be a sales representative with a home office; or an employee who is telecommuting.

Sales & Use Tax Nexus Creating Activities

Soliciting sales through the use of an employee, dependent or independent contractor.

Soliciting sales through an employee, dependent or independent contractor creates a physical presence for a taxpayer. The sales solicitation must be through some form of physical visitations. Merely soliciting sales via a catalog or web site is not enough to create physical presence for a taxpayer.

Installing or repairing property in a state through the use of an employee, dependent or independent contractor.

Installing property in a state through the use of an employee, dependant or independent contractor creates a physical presence for a taxpayer.

Sales & Use Tax Nexus Creating Activities

Conducting training sessions in a state.

Conducting training sessions in a state creates a physical presence for a taxpayer.

Attending trade shows in a state (although some states specifically exempt attendance at trade shows).

Whether attendance at trade shows is sufficient to create nexus for an out of state taxpayer varies by state. The states determination often varies upon the activity taking place at the trade show:

- Displays at Trade Shows
- Selling at Trade Shows
- Buying at Trade Shows

Franchise Tax Nexus Creating Activities

Franchise Tax Nexus Creating Activities

The standards for determining if a taxpayer has nexus for franchise taxes are similar to those for sales and use taxes. If a taxpayer has nexus for sales and use tax purposes, it likely has nexus for franchise tax purposes as well.

In addition, a taxpayer may be required to file franchise tax returns, even if there is no physical presence, in its state of formation, incorporation, etc.

Income Tax Nexus Creating Activities

Income Tax Nexus Creating Activities

Determining if a taxpayer has income tax nexus is dependant upon the taxpayer's business activities (the sales of tangible personal property, services, or both).

If the taxpayer sells tangible personal property, P.L. 86-272 will govern whether they have established nexus. That is, the taxpayer's activities in the state must exceed "mere solicitation."

If the taxpayer performs services, P.L. 86-272 does not afford any protection. Therefore, if the taxpayer has physical presence in the state (consider the activities that create sales and use tax nexus), a state can assert its jurisdiction and subject the taxpayer to an income tax.

Voluntary Disclosure & Amnesty

Voluntary Disclosure & Amnesty

<u>Voluntary Disclosure Agreements ("VDA's")</u>

Voluntary disclosure programs are offered by many states to business taxpayers who are not in compliance with state tax laws. While the requirements differ by state, a requirement that is fairly standard from state to state is that the company must not have been previously notified by the state or an agent thereof in relation to any outstanding liability. Some states also hold their programs open only to those companies that are not registered for sales and use tax purposes in the state. The company is required to pay the outstanding taxes plus interest, and is generally required to register and file on a prospective basis.

Voluntary Disclosure & Amnesty

Voluntary Disclosure Agreements (cont.)

The advantage of a company entering into a VDA with a state is that:

- The state will often limit the lookback period (the period in which they will go back and assess tax) to a limited period, such as three or four years.
- The state will also generally waive penalties associated with any outstanding tax liability. It is rare that a state will waive interest on outstanding liabilities.
- The State generally agrees not to audit periods prior to those negotiated under the agreement.

Voluntary Disclosure & Amnesty

Amnesty

On occasion, in addition to the voluntary disclosure programs, states will offer companies the opportunity to voluntarily pay back taxes by offering an amnesty program. Tax amnesty is an opportunity for companies to pay taxes owed to the state without penalties, and often at reduced interest rates. Amnesty programs are generally only offered for a limited period of time (i.e., one month, four months, etc.), but often cover all open years for taxes. As with voluntary disclosure programs, the requirements are different by state, and should be closely reviewed.

Voluntary Disclosure & Amnesty

Amnesty

Amnesty programs can be differentiated from voluntary disclosure programs as follows:

- Amnesty programs often offer reduced interest rates on payment of taxes, whereas voluntary disclosure programs often charge interest at the statutory interest rate.
- Amnesty programs may often include taxes, which have been previously assessed by the State, whereas in order to participate in a voluntary disclosure program, a company must not have been previously notified by the State of an outstanding liability.
- Amnesty programs often do not have a limited lookback period, whereas voluntary disclosure agreements do.
- Amnesty agreements often require a taxpayer to waive their rights to protest a tax assessment or to apply for refunds of taxes for the period included in the agreement.

Amnesty Programs

- **Florida**
  - July 1, 2010 through September 30, 2010.
  - Applicable to all tax liabilities incurred prior to July 1, 2010
  - All penalties and one-half interest waived for eligible taxpayers (25% of interest waived for those under audit or pursuant to a notice)
- **Illinois – Waiting for Governor's Signature**
  - October 8, 2010 through November 8, 2010
  - Applicable to delinquent taxes as of July 1, 2009
  - Limited lookback to June 30, 2002
  - ALL penalties and interest waived
- **Pennsylvania**
  - April 26 – June 18, 2010
  - Applicable to delinquent taxes as of June 30, 2009
  - Limited lookback to July 1, 2004
  - All penalties and one-half interest waived for eligible taxpayers
- **North Carolina (Internet Transactions Resolution Program)**
  - April 23 – June 30, 2010
  - 4 year limited lookback period
  - Penalties and interest waived for eligible taxpayers
- **Nevada (Pending)**
  - July 1, 2010 – October 1, 2010
- **New Mexico (Pending)**
  - TBD
- **Recently completed programs: AL; AZ; CT; DE; HI; LA; MA; ME; MD; NJ; VT; and VA**

Questions?

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