



CCH Connections

User Conference 2014

State Tax Issues of Services and Service Businesses

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Today's Discussion Topics

- Jurisdictional Issues & Tax Nexus
- Economic Nexus for Service Providers
- Types of Potential Taxes
- Apportionment Issues
- Personal Income Tax Issues on Owners and Employees
- Payroll Withholding
- Sales Tax Issues and Taxable Services



Section 1

Nexus Issues for Service Businesses

Nexus: *The All-Important Term*

What does
it **mean**?



Why is it
important?



Constitutional Nexus: *Due Process Clause*

- No state shall “deprive any person of life, liberty or property without due process of law
- *Mobil Oil*: U.S. Supreme Court says this prohibits a state from taxing an out-of-state corporation unless there is some “minimal connection” between the company and the state
- An “economic presence” is enough though, so said the Court in *Quill*.

Constitutional Nexus: *The Commerce Clause*

- *Quill v. North Dakota (1992)*: But a different rule applies under the Commerce Clause
- Let's get physical



De Minimis Rule: Is There Such a Thing?

- Is there such a thing as a “little bit of nexus?”
- Constitutional Basis: *Quill*’s “few floppy disks”
- NY’s *Orvis* Case: “More than a slight presence” test
 - 8-12 visits
 - Michigan and Illinois Follow Suit
- Most states say a couple visits is enough

Examples of Physical Presence Nexus

- International Law Firm
 - Satellite Office - easy
 - Admitted Pro Hac Vice
 - Attendance at Deposition
 - Client Meeting
- Accounting Firm
 - Client Visits
- Financial Services Firm
 - Client Visits
 - Travelling Roadshow

Real World Scenario

- Minnesota Department of Revenue “Sting”
 - 2013 Operation
 - Targeting large law firms
 - Found the firms by reviewing 1099s issued by Minnesota based companies
 - Seeking 2005-2011 taxes
 - MN agreed in most cases to three-year look-back and no penalties
 - Hodgson Russ v. Minnesota

Takeaways on Physical Presence Nexus

- Per Quill, physical presence creates nexus for sales tax purposes
- Income tax nexus may be LIGHTER standard (see economic nexus discussion)
- Thus, physical presence likely creates nexus for ALL tax purposes

Economic Nexus

- Economic Nexus - An Income Tax Concept
- Geoffrey and South Carolina - It All Starts With The Giraffe
- Opening the Flood Gates
 - Other States Jump On The Bandwagon

Economic Nexus

- Economic Presence = Nexus
 - New York - new “Dr. Evil Rule”
 - Iowa - *KFC v. Iowa*: Kentucky-Fried Nexus
 - North Carolina - *A & F Trademark v. Tolson*
 - Oklahoma - *Geoffrey v. Tax Commission* (Can’t We Leave the Giraffe Alone)?
 - New Mexico - *Kmart v. Dept.*
 - Maryland - *SYL v. Comptroller*
 - Louisiana - *Dept. of Revenue v. Gap*
 - New Jersey - *Lanco v. Division*
 - West Virginia - *Tax Commission v. MBNA*

Economic Nexus

- Economic Presence = Nexus
 - Missouri - *Acme* and *Gore*
 - Ohio - *Couchot*
 - Illinois - *Borden Chemicals*
 - Washington - *General Motors* and *Lamtec*
 - North Carolina - *A&F Trademark*
 - Indiana - *MBNA* and *Letter Rulings*
 - Alabama - *Lanzi*
 - Massachusetts - *Capital One v. Comm'r* (The State Is In Your Wallet!)

Economic Nexus

- Economic Presence ≠ Nexus
 - Alabama - *Cerro Copper v. Dept.*
 - Texas - *Bandag v. Rylander*
 - Montana - *Acme Royalty v. MO*
 - Indiana - *MBNA v. Indiana*
 - Tennessee - *JC Penney and AOL*

Economic Nexus

- Factor Presence Nexus

- California -- \$50,000 of property; \$50,000 of payroll; \$500,000 of sales
- Colorado -- \$50,000 of property; \$50,000 of payroll; \$500,000 of sales
- Ohio -- \$50,000 of property, \$50,000 of payroll; \$500,000 of sales
- Washington -- \$50,000 of property; \$50,000 of payroll; \$250,000 of sales

Economic Nexus

- Ownership of Partnership Interests?
 - General vs. Limited Partners
- Ownership of Leased Property?
 - Mobile vs. Immobile Property
- Qualify to do Business = Nexus?
- Presence of Telecommuters?
 - Home Office Employee Create Nexus

Final Nexus Points

- PL 86-272 is a non-issue for this topic
 - Income tax protections only available to sellers of TPP
- Marketplace Fairness Act?
 - Attempt by Congress to impose tax on all remote sales
 - Mainly concerned with e-commerce retail traffic
- Location of people = nexus



Section 2

Income Tax Issues for Service Businesses

Applicable Taxes on Service Providers

- Entity level taxes on businesses
 - C corps: income-based and gross receipts taxes
 - Apportionment often the issue, especially in the services realm
 - Pass-through entity-level taxes
 - Identifying the states, and dealing with apportionment
- Personal Income Taxes
 - On nonresident owners of pass-throughs
 - On employees

More Taxes on Service Providers

- Payroll Withholding Taxes
- Sales Taxes on Services
- Use Taxes on Consumables

Applicable Entity Level Taxes

- Basic Income-Based Entity Level Tax
 - Most states impose some sort of income-based tax on entities like C Corps
- Look-out for Taxes on Pass-Through Entities
 - S Corps: CA, DC, IL, KS, KY, MA, MI, NH, NYC, OH, PA, TN, TX, WA, WV
 - Partnerships: AL, CA, DC, IL, KS, KY, MI, NH, NJ, NYC, OH, TN, TX, WA, WV
 - LLCs: Similar to partnerships, in general

Apportionment Issues

- How do I compute tax?
- Issue will arise for C corps when determining measure of tax
- Issue also arises for pass-throughs
 - For entity-level taxes
 - To determine tax on owners
- Types of Apportionment Methods
 - Three-factor apportionment of property, payroll, receipts
 - Single-factor apportionment (receipts only)

Apportionment Factors and Services

- Traditionally states used the “Massachusetts” factor which was an equally weighted three-factor formula including sales, property and payroll.
- Many states have modified the traditional formula by adding weight to the sales factor.
- Payroll and Sales factors are the most troublesome, especially in the services context.

Property Factor

- The property factor is generally a fraction with the numerator being value of real and tangible property in-state and denominator being of property everywhere:

Instate Property
Everywhere Property

- What about “property” like computer servers?

Payroll Factor

- The payroll factor is a fraction the numerator of which is the corporation's compensation in a particular state divided by the denominator which is the taxpayer's total compensation everywhere:

$$\frac{\text{Instate Payroll}}{\text{Everywhere Payroll}}$$

- Compensation usually includes wages, salaries, commissions; generally anything showing up on an employee's W-2 or in the company's state unemployment reports.

Payroll Factor

- If an employee works in more than one state:
 - Allocate the compensation to the state in which most of the services are performed;
 - If no one state has a majority assign the compensation to the
 - Employee's base of operations
 - Location from which duties are directed or controlled
 - Employee's state of residency

Sales Factor

- The sales factor is a fraction the numerator of which is the corporation's sales in a state divided by the denominator which is its total sales everywhere:

$$\frac{\text{Instate Sales}}{\text{Everywhere Sales}}$$

- Sales are usually sourced by destination for sales of goods, but it's tougher for services

Sales Factor Issues

- Cost of performance: Source where income producing activity takes place
 - Direct costs determined in a manner consistent with GAAP
 - Income Producing Activity (IPA) is determined from each transaction that goes into making a profit
 - Many states pick up activities performed on behalf of taxpayer by independent contractor in determining direct cost
 - This is the MTC rule

Sales Factor Issues



- Majority cost of performance
 - More than 50% of activity performed in taxing state.
 - State A 60%, State B 10%, State 30%. All receipts go to State A.

Sales Factor Issues

- Preponderance of cost of performance
 - All receipts are sourced to state where greatest proportion of the income producing activity is performed
 - State A 40%, State B 30%, State C 30%. All receipts go to State A.

Sales Factor Issues

- Pro rata cost of performance
 - Gross receipts are pro rated to multiple states based on the cost of performing the service in each state.
 - State A 35%, State B 40%, State C 25%. Receipts go to all three states.

Sales Factor: Market-Based Sourcing

- Most states use cost of performance, but trend towards market-based sourcing
- States which use market-based sourcing:

Alabama, Arizona, California, Georgia, Illinois, Iowa, Maine, Maryland, Michigan, Minnesota, Nebraska, New York, Ohio, Oklahoma, Utah and Wisconsin

Sales Factor: Market-Based Sourcing

- Market-Based Sourcing: UDIPTA Rule
 - Looks to “if and to what extent” the service is delivered to a location in a state
 - If delivery cannot be determined sourcing location should be “reasonably approximated”
 - Includes a “throw-out” provision when taxpayer is not taxable in state to which sale is assigned (or if state of assignment cannot be determined)
- Practical Application?
 - How does a professional service firm allocate based on market sourcing?

Personal Income Tax Issues

- Nonresident Owners
 - Partners, S corp shareholders, LLC members
- Tax Computation Methodologies
 - Three-factor apportionment
 - Direct accounting
 - Entity v. Aggregate Approach
 - Mixing and Matching in NY: difference between LLCs and S Corp factor-based apportionment

Personal Income Issues

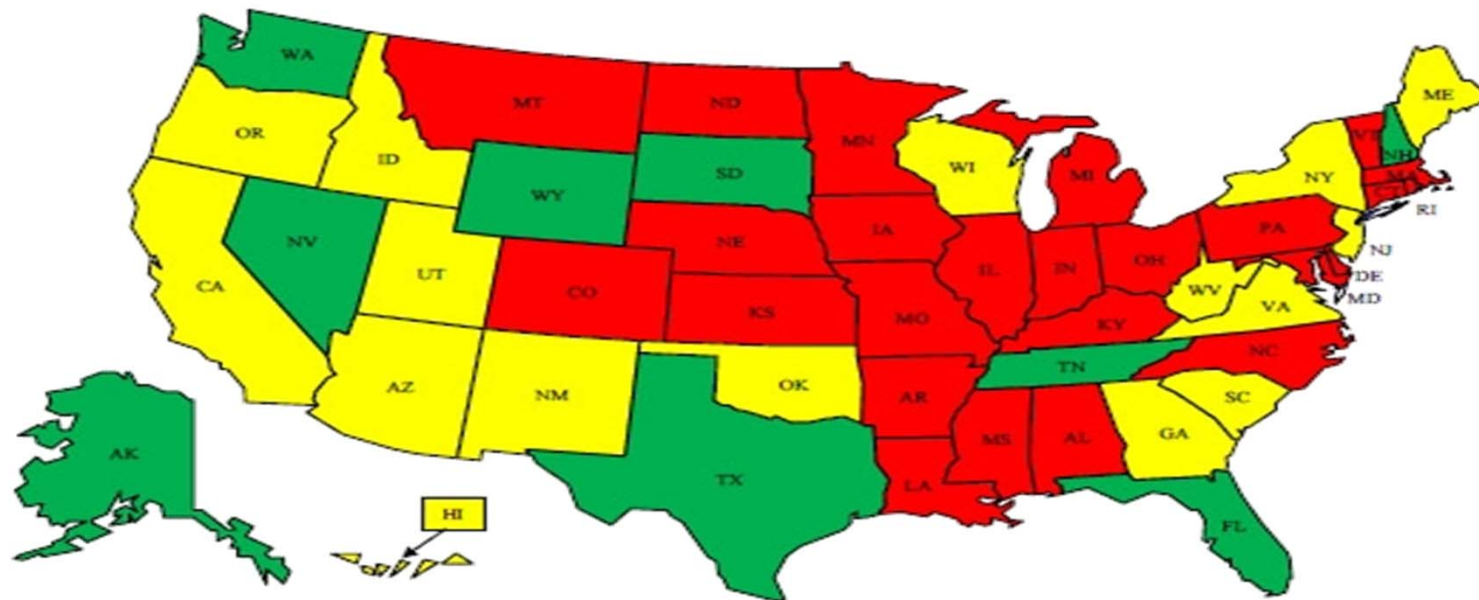
- Tax on employee wages
 - Work days in/out method
- Availability of resident credits?
 - Easy answer for employees
 - Can get tricky for pass-through owners

Payroll Withholding

- No Threshold: AL, AR, CO, DE, IA, IL, IN, KY, KS, LA, MD, MA, MI, MN, MO, MS, MT, NC, ND, NE, OH, PA & VT
- Income Thresholds: ID, OK, OR, SC & WI
- Time Thresholds: AZ, CT, GA, HI, ME, NM & NY

Thresholds

Nonresident Personal Income Tax Withholding



- Key
- Red: Nonresident employees subject to tax withholding on *first day* of travel
 - Yellow: Nonresident employees subject to tax withholding after reaching threshold (see Appendix A for details)
 - Green: No general personal income tax (or, in the case of Washington, DC, no tax on nonresidents)

Practical Problems

- Frequent traveling employees
- Withholding rules vary state to state
- Can technology track movement?
- Increased enforcement by states
- Sec. 404 of Sarbanes-Oxley

Managing Compliance and Practical Solutions

- Doing a Multistate Compliance Review
 - How many employees visit?
 - How many total visits?
 - Total compensation paid to visiting employees?
 - Existence of thresholds?
 - Active in withholding area?

Managing Compliance and Practical Solutions

Sample Compliance Chart

STATE	NO. OF EMPLOYEES VISITING STATE	TOTAL NO. OF VISITS	DE MINIMIS THRESHOLD FOR NONRESIDENTS?	RECIPROCAL AGREEMENTS IN EFFECT?	COMPLIANCE ACTION
LA	25	563	No	No	High activity state, with many employees over 25 days. State doesn't appear to have active criminal enforcement outside the sales tax area, but the high number of visits is problematic. Voluntary disclosure may be the best option.
NY	14	195	14 day rule	No	5 employees surpass 14 day threshold. NYS has been aggressive both on the withholding tax side and with respect to criminal enforcement. Thus, voluntary disclosure is also the best option. Going forward, put measures in place to track 14 day rule.
IL	10	88	Maybe	IA, KY, MI and WI	Employees' services could be considered localized elsewhere and services in IL incidental if they are temporary, transitory, or isolated; at the very least this could give us an argument for no withholding. Consider future compliance options.
SC	16	35	\$1,000	No	Low number of visits; some could fall below threshold; status quo for now.

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Managing Compliance and Practical Solutions

- Special Considerations for Voluntary Disclosures
 - Do employees disclose also?
 - Is payment on behalf of employee = taxable income?
 - Resident credits for employee in home state?
- Special Considerations for Audits
 - What to do?
 - Practical guidance from the front lines



Section 3

Sales Tax Issues for Service Businesses

General Rules Regarding Sales Tax Imposition

- 🌐 In virtually all the states, all sales of tangible personal property are considered taxable, unless an exemption applies.
 - So, for example, sales of goods to governmental agencies, non-profit, charitable, religious, etc. would be non-taxable if a properly executed exemption certificate is received by the seller from the buyer.
- 🌐 However, in most states, the sale of services is only taxed when the service is specifically enumerated as taxable in the statute.
 - So, for example, a statute might read that “the repair, painting or alteration of tangible personal property is taxable.”

General Rules Regarding Sales Tax Imposition

- 🌐 In addition to taxing services associated with tangible personal property, many states specifically enumerate other types of services that are taxable.
 - So, for example, a statute might impose tax upon pest control services, landscaping, pet grooming, etc.

Hint: While in many cases these distinctions seem clear, in others they are not.

Services Typically Subject to Sales Tax

- Utilities (gas, electric and telecommunications)
- Lodging
- Meals
- Information Services
- Repair and Installation
- Cleaning and Maintenance Services
- Landscaping
- Personal Grooming (barbers, hair dressers, tanning salons and beauty care)
- SaaS?

Services Generally NOT Subject to Tax

- Legal Services
 - Financial Services
 - Consulting/Personal Services
 - Accounting Services
 - Engineering Services
 - Architecture Services
- } But be careful!

Service or TPP?

- Service providers should be on lookout for “true object” or “primary function” test
- NY’s dating-services case: selling tapes or dates?
- Easy ones
 - Legal/accounting services
- Tougher
 - Database access/reports

Bundling Problems

- Combination of taxable good/service and nontaxable
- The “cheeseboard rule”
 - Cheese = \$5
 - Board = \$10
 - Total sale = \$15
- Must separately state!
 - Software & Services
 - Info Services & Consulting

Select Sales Tax Issues

- Information Services
 - DC, FL, HI, NJ, NM, NY, SC TX, WV
- General Rules
 - Personal/Individual Test
 - “Common Database” Rule
- Select Industries
 - Market Research - Common Database Issues
 - Investment Research
 - P & I Test
 - Bundling Problems (see above)

Cloud Computing = A New Type of Service?

- National Institute of Standards & Technology (NIST) Definition
 - “Model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g. networks, servers, storage, applications and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction”
- Core Idea
 - Cloud computing allows users with remote access to software, storage capabilities, etc.
 - Include SaaS, PaaS, IaaS
- See Noonan’s Notes Articles on this Issue in Materials

Question

- You used CCH's cloud-based ProSystem FX Software to prepare a tax return. What did you buy?
 - Software
 - Tax return preparation service
 - None of the above

Cloud Computing - Taxability Issues

- Central Issues
 - Is there a taxable good or service?
 - Some states treat as simple license of software
 - Others classify as nontaxable service
 - Is there a sale or use
 - i.e., does “possession” get transferred?
 - Where is the sale taxed?

Multistate Survey

Cloud Computing Taxable (15): AZ, CT, DC, HI, IN, NM, NY, OH, PA, SD, TX, UT, VT, WA, WV

Cloud Computing Exempt (31): AL, AR, CA, CO, FL, GA, IA, ID, IL, KS, KY, LA, MA, MD, ME, MI, MN, MO, MS, NC, ND, NE, NJ, NV, OK, RI, SC, TN, VA, WI, WY

Select Sales Tax Issues

- Contractors
 - Maintenance/Repairs: Taxable
 - Capital Improvement: Nontaxable
 - Adds Value
 - Affixed
 - Permanent
 - Scaffolding Issues in NY

Select Sales Tax Issues

- Don't forget about use tax!
 - Generally in your "home state"
 - Liable for tax if vendors don't collect
 - Sales tax audit issues
 - Sales
 - Capital
 - Expenses

Conclusion



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