

## SALES & USE TAX

Sales tax is one of the most interesting, and challenging, taxes. It's interesting because it involves clients in every possible industry. *Every* business has sales tax exposure, no exceptions. Even if your business does not make taxable sales (like us!), no doubt you still make taxable purchases of goods and services used in the business (think desks, computers, software, paper, pens, utilities, etc.). Even tax-exempt organizations (charities, religious organization, etc.) must worry about sales tax compliance in several states, including New York State.

But while state tax practitioners like us enjoy working on these matters, we sympathize with our clients who find sales and use tax particularly intimidating for three specific reasons: (1) sales and use tax rules can be counterintuitive and confusing, (2) many businesses now utilize the internet to make sales across state lines, and those businesses need to comply with sales tax rules in multiple states, and (3) these rules are constantly changing. You can keep up with many of these issues by subscribing to our sales tax blog *All About Sales Tax*.

All of this adds up to one daunting conclusion: it's easy for a business to make a mistake with respect to sales tax compliance. And, unfortunately, when a mistake is made with sales tax, the repercussions are perhaps the harshest of any tax. There are a couple of factors in play here. First, although sales tax rates are almost always single-digit, the tax base is gross receipts and not net income; so even a business without any profit is subject to the tax. Second, the resulting tax liability is frequently assessed not just against the business, but also against the individuals responsible for operating the business. In other words, sales tax (even uncollected sales tax) can lead to personal liability! So not only are the rules in this area difficult to understand and tough to stay current with, but the stakes for any compliance failures can be extremely high.

For more than 50 years, Hodgson Russ attorneys have been called upon to help thousands of clients navigate complex and confusing sales and use tax issues. Every client, no matter how sophisticated, has questions and concerns. We can handle your issues no matter where you are in the process. We have successfully helped startups correctly apply the sales tax rules to their activities across multiple states. We have successfully defended audits across the country, and, in particular, in New York State. And we have successfully litigated cases where the taxing authorities have advanced an incorrect position that exceeds their authority under the applicable sales tax rules. So from the first steps of a fledgling startup, to the mature compliance issues of a multinational conglomerate, Hodgson Russ attorneys have the experience to handle your sales tax issues with competence, professionalism, and efficacy.

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### Why is Sales Tax Compliance So Difficult?

Sales tax compliance is particularly difficult because the tax is perhaps the most fact-dependent. In other words, a slight alteration in the facts of a transaction can cause the transaction to transform from a nontaxable sale into a taxable one. For example, in New York State, did you know that the sale of a physical photograph to a customer in the state is typically subject to the state and local sales tax? However, if you take that same photograph, digitize it, and then sell it to a customer in New York State and deliver it digitally, the transaction is suddenly considered to be nontaxable because no tangible property changed hands. One simple change in how the transaction is completed and voila, no tax. But this is a double-edged sword. Change the facts in the opposite direction, and suddenly the seller has a tax collection and remittance obligation.

Now imagine trying to track these rules across the country. That's what faces some businesses that sell to customers remotely (i.e., over the internet, via catalog or phone). Moreover, state and local sales and use tax laws continue to evolve and change at a breathtaking pace.

*Click here to view our "What Businesses Need to Know About Sales and Use Taxes" micrographic outlining how nexus laws vary by state, as well as other state variations.*

As a result, it can feel like you're constantly trying to hit a moving target. This causes it to be virtually impossible for businesses to follow a "one size fits all" approach to multistate sales and use tax compliance. Hodgson Russ is one of the few law firms that has a practice group devoted exclusively to state tax issues in general, and sales tax issues in particular. Our attorneys have decades of experience helping businesses comply with these constantly changing rules. We help clients find practical planning opportunities to reduce their compliance burden by leveraging our knowledge of the various state sales tax rules.

### When Can a State Require an Out-of-State Business to Collect and Remit its Sales Tax?

If your business is the reluctant recipient of a sales tax audit notification letter from another state, your first thought might be to ask, "Why does this state think it can audit my business?" That's a reasonable question because states are prohibited from requiring an out-of-state business to comply with their sales and use tax laws if the out-of-state business has no connection, or nexus, with the state. Unfortunately, when the United States Supreme Court decided *South Dakota v. Wayfair, Inc.* in June 2018, it made it easier for states to force out-of-state businesses to collect and remit their sales taxes.

Prior to *Wayfair*, states could require out-of-state vendors to collect and remit sales tax on sales to customers within a state only if the out-of-state vendor (or an agent or proxy) was **physically present** in the state. To put it another way, before a state could require a vendor to collect its sales tax, that vendor had to be physically present in the state (e.g., through people or property). But in *Wayfair*, the Court reviewed this physical presence standard and basically concluded that it no longer made sense given the rise of the internet and our digital economy.

South Dakota provided the Court with a possible new rule. The state passed a law that said even if an out-of-state vendor didn't have physical presence in the state, it would still have to collect and remit South Dakota sales tax if it had enough of an **economic presence**. South Dakota defined the requisite economic presence to be: either \$100,000 in sales to South Dakota customers, or more than 200 transactions in the state. Many other states have passed similar laws or rules, including

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New York State (\$500,000 in sales and 100 transactions). For a list of the applicable post-Wayfair nexus rules in each state, [click here](#). Finally, states are also passing laws or enacting rules requiring “marketplaces” such as Amazon, eBay, and Etsy to charge and collect tax if their activity creates an economic presence in the state (assuming they otherwise have no physical presence in the state).

As with everything in sales tax, these laws can be confusing, contain drastically different terms and change regularly. Thus, they require a solid understanding of the various provisions. Hodgson Russ attorneys have used their knowledge of these rules to limit our clients’ compliance burdens, and, in some instances, even stop an audit just as a state was trying to start one.

### **Audit Defense Expertise**

There are two primary issues that are addressed during a sales tax audit: (1) did your business remit the proper amount of tax to the state (on both your business’s sales and purchases), and (2) can you prove it? This second question is perhaps the most important issue that arises during an audit because it determines how the rest of the audit will unfold. If you have “adequate records,” then the state auditor is obligated to use those records when determining whether any liability exists during the audit period. In other words, the auditor is constrained by the business’s records. If the business does **not** maintain adequate records, however, auditors are free to estimate the business’s tax liability by using information from external sources. For example, auditors might obtain purchase records from your business’s suppliers and then apply an estimated markup to those purchases to determine the business’s total amount of sales. Another option is for auditors to take an industry-wide statistical average, like total-sales-to-credit-card ratio for a period during which the auditors have a high degree of comfort that the information is accurate, and apply it to the business’s credit card transactions to determine the business’s cash and total sales.

Unfortunately, these estimates invariably allow auditors to conclude that the business under-reported its tax liability. And though an auditor is obligated to choose a reasonable methodology, courts have consistently held that auditors are not required to prove that the audit conclusions are correct. And perhaps the scariest aspect to sales tax audits is the fact that if an auditor uses an estimated methodology to determine a business’s taxable sales, and if those sales end up being higher than the amount of sales reported by the business, then the business could have not only a sales tax liability, but it could also have an income tax problem as well. In other words, sales tax audits can create income tax liabilities. So not only is it critically important to know the complex rules governing which transactions are subject to tax in a given state, but it is also vital that the audit process be handled with great care and skill.

That’s where we come in. Our attorneys have handled thousands of sales tax audits across the country, and, in particular, in New York State. We will work with your in-house tax professionals and/or outside accounts to ensure the best possible audit result. Clients always have dozens of practical questions regarding the audit process such as:

- Where should I hold the audit?
- Should I sign a waiver allowing the state more time to conduct the audit?
- Who should speak to the auditors?

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- Do I really have to provide all the documents requested by the auditors?
- How long will the audit take?
- Will penalties and interest be assessed?

Our State and Local Tax Practice attorneys will be happy to discuss these issues with you.

The firm also publishes an easy-to-read handbook, *What to Expect in a New York Sales and Use Tax Audit*, that many will find as a useful guide for handling sales tax audits.

### Industry-Specific Expertise

Hodgson Russ attorneys have tremendous experience and expertise in the following industries:

- **Technology Sector** – Because sales tax is so fact-dependent, new technology often presents particularly difficult problems. Businesses and auditors often find themselves trying to fit new technology and terminology into antiquated sales tax rules and definitions to determine whether a transaction is subject to tax in a given state. For example, most states tax software sales. But what if a business sells Software-as-a-Service (“SaaS”) or is an Application Service Provider (“ASP”)? Are these transactions subject to tax? Similarly, what if a product uses software to manage a business’s confidential information? Is this taxable software, or a nontaxable personal information service? And, as always, are the answers different in each state in which the business has customers? Hodgson Russ attorneys have helped hundreds of technology companies address these complex and difficult questions. For a brief review of New York State’s rules, take a look at this article.
- **Construction and Contracting** - When it comes to sales tax compliance, few industries have it tougher than the construction industry. In part, that’s because unlike other businesses, contractors must follow a special set of rules in most states. For example, most businesses purchase their inventory tax free as an exempt purchase for resale. On the other hand, most states require that contractors pay tax on purchases of building materials and then track how the materials are subsequently used to determine their compliance obligations. Take a look at recent publications here and here that review these complex issues in New York State. Hodgson Russ attorneys have advised on everything from small capital expansions to massive gut renovations of some of the largest facilities in the world. And we have secured litigation victories on some of the largest projects in New York State. For example, our lawyers successfully argued that the capital improvement exemption applied to a major refurbishment of a bridge in the New York City area.
- **Hospitality – (hotels, temporary accommodation services, restaurants, caterers)** – Hotels, temporary accommodation services, restaurants and caterers face particularly confusing and counterintuitive rules when it comes to sales tax compliance. New York State’s rules for restaurants and caterers are uncommonly broad, taxing virtually any charges made by such businesses. And the resale rules in this area are also unusual. As a result, many restaurants and caterers find themselves facing hefty sales and use tax assessments. Hodgson Russ attorneys have successfully litigated sales tax assessments against food service businesses and the people responsible for running them. Hotels also have significant issues both because they sell taxable (room rentals, food service, storage, technology and telecommunication equipment and services, etc.) and potentially nontaxable items (charges for a conference room), and because they offer loyalty

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programs that can have sales tax implications. Hodgson Russ attorneys successfully defended a sales tax assessment against one of the largest hotel loyalty reward programs in operation. Finally, the rise of temporary-accommodations services like Airbnb have forced states like New York to confront the question of whether revenues generated through temporary stays (e.g. less than 30 days) are subject to sales tax as they would be for “hotel” stays. Aside from questions over compatibility with municipal housing laws, such services have also raised the question in New York State of whether the owners or the services are “hotel operators” for sales tax purposes. New York State also recently changed the sales tax structure applicable to online travel sites and “room remarketers,” effectively treating them as hotel operators, even though they merely remarket/resell other hotel operators’ rooms. Hodgson Russ attorneys can help your hospitality business navigate these complicated and constantly-changing issues.

- **Sales of Business Assets** – Sales of a business’s assets present unique and often surprising issues. Though most states provide a sales tax exemption for isolated or occasional sales of business assets, some (including New York State) do not. And even if the assets themselves are not subject to tax in a given state, the purchaser of the assets must be particularly careful because most state sales tax laws contain a provision that imposes successor liability on the purchaser for any unpaid sales tax debts owed by the seller. That’s right, the purchaser can become liable for the seller’s sales tax debts, in most cases even if they are not yet assessed by the state. For a brief review of these issues in New York State, take a look at this article that discusses both the taxability of the assets and the considerations for avoiding successor liability.
- **High-End Luxury Items** - New York State has long grappled with the enforcement of use tax on big-ticket items such as artwork, jewelry, high-end wine and spirits, aircraft, vessels, and motor vehicles that residents have purchased out-of-state, but brought into New York State. Certain tax planning allowed New York State residents to structure such purchases to avoid or defer the large sales tax hit on such items. And New York State for many years has been aggressive in addressing these perceived loopholes, resulting in numerous audits and legislative amendments. Recent enforcement efforts by the Department of Taxation and Finance have included accessing customs records to identify artwork and other expensive items entering the state on which sales tax may not have been paid. New York State-based galleries and art dealers have also felt the pinch, with the Department focusing on whether sales to out-of-state buyers are, in fact, “in-state” sales (the question turns on whether delivery occurred via “common carrier” or “private carrier”). New York State recently decided to take a more taxpayer-friendly approach to airplanes and boats, though. Effective September 1, 2015, New York State amended the tax law to exempt “general aviation aircraft” from sales and use tax altogether—joining an already existing exemption for “commercial aircraft.” Together, the exemptions mean sales of almost all aircraft are now exempt from tax. Additionally, effective June 1, 2015, New York State relaxed the rules regarding taxation of sales and uses of vessels in New York State. For vessels, only the first \$230,000 of the purchase price is now subject to tax. Also, a vessel purchased out of state can now enter New York State waters without triggering any liability for use tax as long as it does not spend more than 90 consecutive days within the State and is not registered in New York State (or required to be). But the rules can still be very confusing regarding artwork, wine and spirits, jewelry, and other high-end items. Schedule a call with one of our State and Local Tax Practice attorneys to review these complex issues.

### Steps of a Tax Audit

See below for what to expect in a New York State Tax Audit:

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### **In the News**

After the Move – Part II: New York State’s Income Sourcing Rules for Business Sales

*TaxStringer*, September 1, 2023

After the Move – Part I: New York State’s Income Sourcing Rules for Telecommuting and Deferred Compensation

*TaxStringer*, August 1, 2023

New York Tribunal Says Siblings Received Distributions, Not Loans

*Tax Notes*, March 4, 2022

### **Press Releases**

Two Hodgson Russ Attorneys Selected to Author Monthly Columns in Tax Notes State

*Hodgson Russ Press Release*, April 27, 2020

### **Publications**

Empire Zone Strikes Back: A New Hope in an Apportionment Battle

*Tax Notes State*, March 4, 2024

NY Tribunal Ruling Instructive On Sales Taxation Of Artwork

*Law360*, April 6, 2022

Industrial Development Agencies in New York State

*Tax Notes State*, August 17, 2020

Christie's Fined, 'Common Carriers' Defined: NY Sales Tax and Art

*Tax Notes State*, July 6, 2020

Apple Gets Bit by New York Sales Taxes

*Tax Notes State*, February 24, 2020

### **Presentations & Events**

Syracuse Chapter Taxation Conference

Embassy Suites - Syracuse Destiny, November 1, 2023

Tax Strategy Series: Domicile and State Residency

March 22, 2023

2023 ABA – IPT Advanced Tax Seminars

Royal Sonesta Hotel, New Orleans, LA, March 13 - March 17, 2023

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Syracuse Chapter Taxation Conference  
Embassy Suites – Syracuse Destiny, November 2, 2022

Sales Tax Issues for Developers and Operators of Affordable Housing Facilities  
November 2, 2022

New Jersey Audit Process and Updates from the Division of Taxation  
New Jersey Law Center, September 15, 2022

2021 Hodgson Russ Summer Tax Series  
July 14, 2021

State Tax Issues of 2020 Fall Webinar Series  
October 21 & 28 and November 4 & 18

New York Sales and Use Tax Update and Hot Topics  
October 28, 2020

2020 Hodgson Russ/CCH (Summer) Tax Webinar Series  
Wednesdays, May 6 - June 17