STATE & LOCAL TAX ISSUES AFFECTING SMALL TO MID-SIZED BUSINESSES

Tulsa Chapter - OSCPA

May 20, 2015

With You Today

Contacts

Brent Watson CPA
Manager – Grant Thornton LLP
(918) 877-0800
brent.watson@us.gt.com

Learning Objectives:

– Recognize Important State & Local Tax Issues that commonly apply to small and mid-sized business

- Sales Tax
- Property Tax
- Multi-state Income Tax
- Multi-state Payroll Tax
- Credit & Incentives

Disclaimer:

- Information offered in this class is of necessity general in nature and is not presented as advice to be relied on in specific situations. Users should always consult with an expert about their specific circumstances.
- The presenter is offering this information as a public service, and no contract exists with those attending the presentation

SALES & USE TAXES

Brent Watson CPA
Manager, Tulsa

Grant Thornton | An instinct for growth™

Recent Developments - Arkansas

– Manufacturers can obtain a ***limited*** *DP* to allow them to make purchases of repair parts & services at a reduced rate of tax. (Formerly the phased in exemption required the taxpayer to obtain a DP). *Effective now.*

– Local Tax Rebate – limitation for timeframe for eligible purchases on which a refund claim can be made is increased from 6 months to 12 months. *Effective October 1, 2015.*

Recent Developments - Arkansas

– Sand and other proppants used to drill, re-complete, re-drill, or expand wells is exempt.
– An exemption to the tax imposed on solid waste services is created for collection of waste products produced during exploration and drilling.

Both of these effective October 1, 2015.

Recent Developments - Missouri

- Amnesty Program to be in place September 1 through November 30, 2015
- Applies to Income, Sales and Use & Franchise taxes
- Waiver of all P&I

Recent Developments - Oklahoma

- – HB 1741 – Prohibits payment of contingent fees to third-party providers of audit services working for taxing authorities. Passed House, still in Senate @ 5/17/2015.
- – HB 2236 – Amnesty – Would provide for a tax amnesty period: September 14, 2015 to November 13, 2015. Passed House, still in Senate @ 5/17/2015.

Recent Developments - Texas

– *Southwest Royalties v. Comptroller* – Court of Appeals again ruled that downhole pumps and piping is not manufacturing equipment, but is taxable as extractive equipment. TX Supreme Court has not yet agreed to hear the case.

Resale Exemption - 1

- What the resale exemption covers – The resale exemption applies to items that are resold – applies to packaging, ingredients, merchandise
- How to claim the resale exemption:
  - Sellers located in a state in which purchases for resale are made should have a sales tax permit
  - Sellers not located in a state in which purchases for resale occur are allowed by *most (not all)* states to use their home state's sales tax permit

Resale Exemption - 2

- A seller should collect tax from customers unless the purchaser supplies a valid exemption certificate.
- Drop shipments and the resale exemption
  - Drop shipments – seller delivers to buyer's specified location for buyer's customer
  - Treated as a sale for resale in most states but not in: CA, CT, DC, FL, MA, MD, & MS (TN through June 30, 2015)

Resale Exemption – 2b

– Drop shipments and the resale exemption
  - States that do not treated drop shipments as sales for resale treat the sale as a taxable sale.
  - In these states, if the intermediate party (buyer) cannot supply an exemption certificate, the sale is taxable. And, these states will NOT allow the intermediate buyer to provide a resale certificate.

Resale Exemption – 2c

- Drop shipments and the resale exemption
  - Some of these states (example: CA, MS) allow the seller to accept an exemption certificate from the ultimate customer (receiver of the goods) based on their exemption (i.e. non-profit, etc.); others do not (example MD).

Resale Exemption - 3

- Leases - If an item is purchased for the purpose of being leased out, the purchaser should claim the resale exemption on the purchase, and then collect tax on the rental invoices.
- Sales & Leasebacks – In most states, including OK, the entire sale and leaseback is treated as a non-taxable transaction. IN OK, it is excluded from the definition of a "sale" for sales tax law. Laws vary somewhat for other states.

Resale Exemption – 4*

– Exemption Certificates
  - Once an audit is in process, sellers have limited time to gather these, it may be difficult to find the contact at the customer to provide these, the standard for validity is higher, and often, the seller does not cooperate – out-of-business, etc.

Resale Exemption – 4*

– Exemption Certificates
  - Proper procedures to either gather a valid exemption certificate or collect tax on new customers or new states in which a customer begins to make purchases are crucial tax policies for distributors, manufacturers, and others making multi-state sales.

Resale Exemption - 4

- Exemption Certificates
  - What constitutes a valid exemption certificate
    - Some states certificates expire (OK, et al)
    - Special forms required for some exemptions (MSEP, governmental agencies, non-profits, etc. in OK)
    - Generally, most states require more than a copy of the purchaser's permit – signature, date, reason stated for exemption, etc.

Resale Exemption - 5

- Exemption Certificates
  - Multi-state exemption certificate issues
    - Most states will accept the Multi-State Tax Commission form, but about 11 do not
    - Most states will accept a form that includes the purchaser's home state sales tax permit number, but a few do not. This is an issue for brokers, drop shipments, etc.

Resale Exemption - 6

- Exemption Certificates
  - Maintenance and Tracking of exemption certificates
    - Tools exist for imaging and accessing exemption certificates for customers, and interfacing them with sales tax software
    - Additional services are provided that can be used to determine what certificates are valid, and for automating collection

Manufacturing Exemption - 1

– The manufacturer MUST obtain an MSEP ***prior*** to claiming the exemption. Vendors MUST obtain a copy of the MSEP to document the non-collection of tax.
– The OTC has proven to sometimes be overly resistant to granting an MSEP – i.e. "custom".
– The obtaining of an MSEP by the buyer before the sale of manufacturing equipment is critical to avoiding unnecessary tax exposure.

Manufacturing Exemption - 2

- Basics of the manufacturing exemption: **Section 1359 Exemptions—Manufacturing.—** There are hereby specifically exempted from the tax …:

  Sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a **manufacturer** for use in a **manufacturing operation**.

- This is a VERY broad exemption – includes consumables – welding gases, lubricants, etc.

Manufacturing Exemption - 3

- Begins where materials enter manufacturing site, and continue through the point where the items leave the site (<u>68 O.S. Sec. 1352(15)</u>
- This is a VERY broad exemption – covers the integrated manufacturing process - includes items like storage racks for materials and goods.
- Machinery, utilities and chemicals consumed for pollution control at treatment facilities permitted pursuant to the Oklahoma Hazardous Waste Management Act.

Manufacturing Exemption - 4

- **<u>Sales</u>** by an OK manufacturer to an out-of-state purchaser for immediate transportation and usage OOS are exempt (Rule 710:65-13-152.1). The seller must obtain an exemption certificate stating that the buyers will be immediately removing the goods for OOS usage.

Other Exemptions Affecting Retailers and Other Businesses

- Exempt Persons:
  - Non-profits (qualifying types only)
  - Indian Tribes (only if used by tribe)
  - Governmental Agencies
- Pollution Control – machinery, chemicals and utilities used at or consumed at facilities that are specifically permitted by the Hazardous Waste Management Act. Application for a permit must be made. Rule 710:65-13-80.

Contractor Issues

- Contractor is the consumer (and taxpayer) in OK and most states
- Exception to contractor paying tax: some entities exemptions pass through to the contractor to allow exempt purchases (Manufacturers)
- Other states tax contractors differently: KS & TX tax repair services to RP; MS – contractor's tax
- Materials received in one state and used in another – can result in multiple payment of tax

Contractor Issues - b

- To avoid potential double taxation or payment of tax at higher rates, a purchase company can be utilized.
- PurchaseCo buys for resale items received into inventory
- PurchaseCo then invoices goods when shipped to locations where used – either OOS or instate, with correct state and local taxes applied

Contractor Issues - c

– Currently some controversy is occurring regarding taxation of separately stated materials used downhole in oil and gas wells. The issue: is the service provider a contractor (and thus consumer of the goods) or a service provider separately billing for materials; and secondly, are the materials consumed or resold. (OK LR-10-086 Oklahoma Tax Commission, August 24, 2011 – says reseller treatment applies…)

Tax Traps Commonly Encountered

– Intercompany Transactions (two legal entities)
  - Treated as arms-length transaction. Does not apply to initial formation or pursuant to a reorganization, winding up, dissolution, liquidation, or formation of a corporation.
  - Occasional/Isolated Sales of Business Assets - OK has no exemption – many states do provide such an exemption

Tax Traps Commonly Encountered - b

- Especially hard to deal with for sales of interest in oil and gas properties. Tax is imposed on value of TPP.
- Credit Card Purchases
  - must retain receipts showing sales tax paid
- Cash purchase of entire businesses – successor liability – request tax clearance

Dealing with the Tax Commission: Audits, Permits, VDAs, & Refunds

- Audits – sampling agreements, Statute of limitations, credits, etc.
  - Sampling – avoid signing sampling agreements that call for block samples; many states (AR, TX) use statistical sampling.
  - Samples chosen should be evaluated: Make sure that credit-bearing accounts are included, that the statistical criteria are acceptable

Dealing with the Tax Commission: Audits, Permits, VDAs, & Refunds

– Permits:
  - Use tax v. sales tax – sales tax is for in-state transactions, while use tax is for interstate transactions. Do not report sales tax on use tax forms, vice-versa. The OTC may claim that no Statute-of-Limitations apply because proper reporting of the tax was not done, they then have been known to try to impose a 7 year look-back period in audits.

Dealing with the Tax Commission: Audits, Permits, VDAs, & Refunds

- Permits:
  - Direct Payment ("DP") Permits – for manufacturers and others – example: temporary storage – useful in OK for local tax; ditto in TX
  - Vendor's Use Tax Permit – for OOS sellers delivering sold goods into the state
  - MSEP – previously covered

Dealing with the Tax Commission: Audits, Permits, VDAs, & Refunds

- Voluntary Disclosure Agreements
  - Limits look-back period, penalties & interest
  - Requires third-party anonymous initiator
  - Do not apply to tax collected, not paid
  - In OK, 3 year; all penalty, ½ of interest, and not available if already registered
  - In many other states, registered taxpayers can still use VDA to mitigate discovered exposures

Dealing with the Tax Commission: Audits, Permits, VDAs, & Refunds

– Refunds of overpaid tax
  - purchases for exempt usages
  - purchases with wrong state's tax charged
  - sales for which customer later supplies exemption certificate
  - sales written off as bad debts
  - wrong local tax paid or accrued (use tax v. sales tax in OK)

Dealing with the Tax Commission: Audits, Permits, VDAs, & Refunds

– Refunds of overpaid tax continued:
  - Consultants have tools to expedite this process, including tools to identify tax paid to vendors
  - Refunds can be obtained either from vendors or from the taxing authority in most cases
  - Assignments of rights – allowed in most states, no formal process required in OK

Compliance Procedures: Collection & Remittance of Taxes

– "FRONT-END" Sales Tax Software:
  - Affordable software exists to interface with billing and purchasing systems to compute and apply sales and use taxes to invoices or A/P transactions
  - Billing systems must have ability to flag items and customers as taxable or not. Usage of sales tax software and exemption certificate management software should be considered.

Compliance Procedures: Collection & Remittance of Taxes

– "BACK-END" Sales Tax Software:
  - Software to report tax – including tax returns
  - Advantage of automation: reduced compliance time, handling of tax refunds to customers, reduced audit expense because of more accurate tax collections, and reduced time dealing with auditors
  - Providers include: Vertex and Avalara

Compliance Procedures: Collection & Remittance of Taxes

- Outsourced preparation of returns:
  - Reduced time and cost to handle compliance
  - Can help avoid late and inaccurate filings
  - Payment of tax can also be automated
  - Handling of notices can be included
  - Avalara and other software firms provide some of these services, but some CPA firms can provide comprehensive services, including assistance with audits

Nexus Considerations

- Common triggers for nexus:
  - Installations or repair services
  - Inventory in state
  - Sales personnel)or any employees in the state) – even if transitory – maintaining a market – contract sales personnel
  - Delivery in company vehicle
  - Related entities with nexus and common functions

Nexus Considerations

– "Mainstream Fairness Act":
  - Would basically replace the concept of nexus based on physical presence with economic presence – sales into a state above a threshold
  - Would allow states to impose sales tax collection duties and liabilities on remote sellers without regard to "nexus"

Nexus Considerations

- "Mainstream Fairness Act":
  - The bill's preamble states, its intended purpose is "to restore States' sovereign rights to enforce State and local sales and use tax laws." – However – would apply to manufacturers, distributors, etc. as well
  - This could be VERY costly for smaller multi-state sellers to comply with. Software to calculate and remit tax will likely be needed.

Nexus Considerations

- "Mainstream Fairness Act":
    - VERY LOW threshold - $1M in nationwide out-of-state sales – regardless of portion of these that are non-taxable
    - Sellers with many smaller widely distributed sales could be required to calculate, bill, collect and remit sales taxes in nearly all states with multitudes of local taxes applicable – or face audit assessments!

PROPERTY TAXES

Common Sources of Overpayments - 1

– Repairs that were capitalized
– Real Property
– Intangibles***
– Ghost Assets
– Failure to claim obsolescence for TPP or even realty that is impaired
– Wrong class life assigned to property

Common Sources of Overpayments - 2

– Intangibles * Computer Software is a subject of debate as to whether or not it is taxable. If it is an intangible, it is not taxable per State Question 766 which passed in 2013.

– No statute or regulations address this question, and no legal cases have apparently addressed the issue to date.

– For sales tax purposes: electronically delivered software is treated as an intangible

Grant Thornton | An instinct for growth™

Exemptions

- Freeport Exemption in OK
  - Exempts inventory held by an OK taxpayer if purchased OOS and being sold OOS
  - Allowed at lower % OOS – purchases or sales
  - Inventory turnover cannot > 9 months
  - Form 901F **must** be filed by March 15.
- Some other states do not tax inventory or provide a Freeport exemption.

Exemptions

- Manufacturing 5 Year Exemption in OK
  - Manufacturers and Large Distribution Centers
  - Threshold requirements: investment of at least $250,000 and an addition of $250,000 in annual payroll in counties with a population of 50,000 or less. If the company is located in a larger county, an additional annualized payroll of at least $1,000,000 is required.
  - May apply to real and personal property

Exemptions

– Manufacturing 5 Year Exemption – cont.
  - Must file claim annually be March 15
  - Years not claimed and late filed are lost.
  - Years remaining on the 5 year period an exemption applies to can still be claimed, even if initial year(s) are lost.
  - Must maintain increased payroll and property to claim the exemption, otherwise, remaining years are lost.

Current Property Tax Legislative Developments

- HJR 1024 – Placing to a State Question – modification of 5 Year Mfg. Ad Valorem Exemption from a state funded exemption to a county funded exemption
  - Eliminates state funding – where state paid taxes to county for exempted items.
  - Exemptions would be approved as long as a unanimous vote by County Commissioners to deny does not occur (if one Commissioner votes in favor, the exemption is granted).

Current Property Tax Legislative Developments

- SB 387 - Manufacturing 5 Year Exemption – calculation of payroll is modified beginning 2016
  - Allows for exclusion of "Base payroll" means total payroll adjusted for any nonrecurring bonuses, exercise of stock options or stock rights and other nonrecurring, extraordinary items included in total payroll.
  - "Initial payroll" means base payroll for the year immediately preceding the initial construction, acquisition or expansion.

Current Property Tax Legislative Developments

- For the purpose of determining payroll, the legislation allows the manufacturing facility to exclude from its payroll any nonrecurring bonuses, exercise of stock options or stock rights or other nonrecurring, extraordinary items included in the total payroll numbers reported to the Oklahoma Employment Security Commission.

CREDITS & INCENTIVES IN OK

Quality Jobs Program

The main qualifying criteria consists of:

(1) Qualifying industry/NAICS code (manufacturing, distribution centers, corporate or regional offices, bio-tech, etc.)

(2) Qualifying wages that must meet an increase of $2.5M in a period of 4 consecutive quarters when compared to a base period prior to the OQJP application (threshold is reduced for certain industries).

Quality Jobs Program

Other qualifying criteria consists of:

(1) Wages at least equal to county average wage, but not exceeding a statewide average

(2) 80% of employees working at least 30 hours weekly

(3) Adequate Health Insurance provision

Quality Jobs Program

"Date Stamp"

Qualifying wages for new hires are determined based on the “date stamp” which is affixed to the application when it is initially completed and submitted to the Oklahoma Department of Commerce (“Commerce”). Any new hires made before the date stamp will not qualify.

Quality Jobs Program – x

Example of potential benefits of QJP:

Net increase in payroll = $2.5M

Rebate percentage = 5%

Rebate annually = $125,000

10 year total = $1,250,000

Investment Tax Credit for Manufacturers

- Applicant must hold an MSEP
- Credit = Greater of 1% of investment or $500/new employee annually for 5 years after the year the credit is earned
- Credit is doubled in Enterprize Zones
- Minimum investment is $50K – small, no minimum employees
- Cannot be taken if Quality Jobs Program benefits are taken – Except – if $40M manufacturing investment – both programs benefits apply

Investment Tax Credit for Manufacturers

– Employees must be involved in manufacturing - either directly of in a support role. Administrative personnel do not count
– Credits can be carried forward for 15 years.

MULTI-STATE INCOME TAX ISSUES

- Nexus issues – additional state income tax filings may be required if certain activities occur
- PL 86-272: taxpayers whose only activity in a state is the mere solicitation of sales of tangible personal property may engage in certain protected activities without triggering a state income tax filing requirement.

MULTI-STATE INCOME TAX ISSUES

– Limitations of PL 86-272:
  - Only applies to taxes dependent on net income – and does not apply to the Texas Margin Tax, Ohio CAT, etc.
  - Almost any service connected with a sale of property by an employee in the state voids this protection
  - The sale of services is not covered by the law
  - Orders taken in a state, such as at a trade show, void this protection

MULTI-STATE INCOME TAX ISSUES

– When related entities have common management and operations activities, consolidated filings of state income tax may be required

MULTI-STATE PAYROLL TAX ISSUES

- States generally require that employers withhold income tax for both resident and non-resident employees that earn wages for performing services within their state
- The mere performance of services by an employee in a state can be sufficient to create an income tax withholding obligation. For example, sales personnel operating out of their homes are subject to payroll taxes for the state in which they reside.
- Treatment varies widely between states. Only a few have de minimis exemptions for non-residents working in the state.

MULTI-STATE PAYROLL TAX ISSUES

– Unemployment taxes are not usually affected when an employee temporarily works in a non-resident state. Instead they are normally determined by the state in which the employee is based, unless they have no fixed base of operations, in which case the tax is usually determined by the employee's place of residence.

CONTACT INFORMATION FOR PRESENTER

- **Brent Watson, CPA**

Grant Thornton, LLP

2431 E. 61st Street; Suite 500

Tulsa, OK 74136

brent.watson@us.gt.com or 918-877-0808 or cell: 918.284.8499

Grant Thornton | An instinct for growth™