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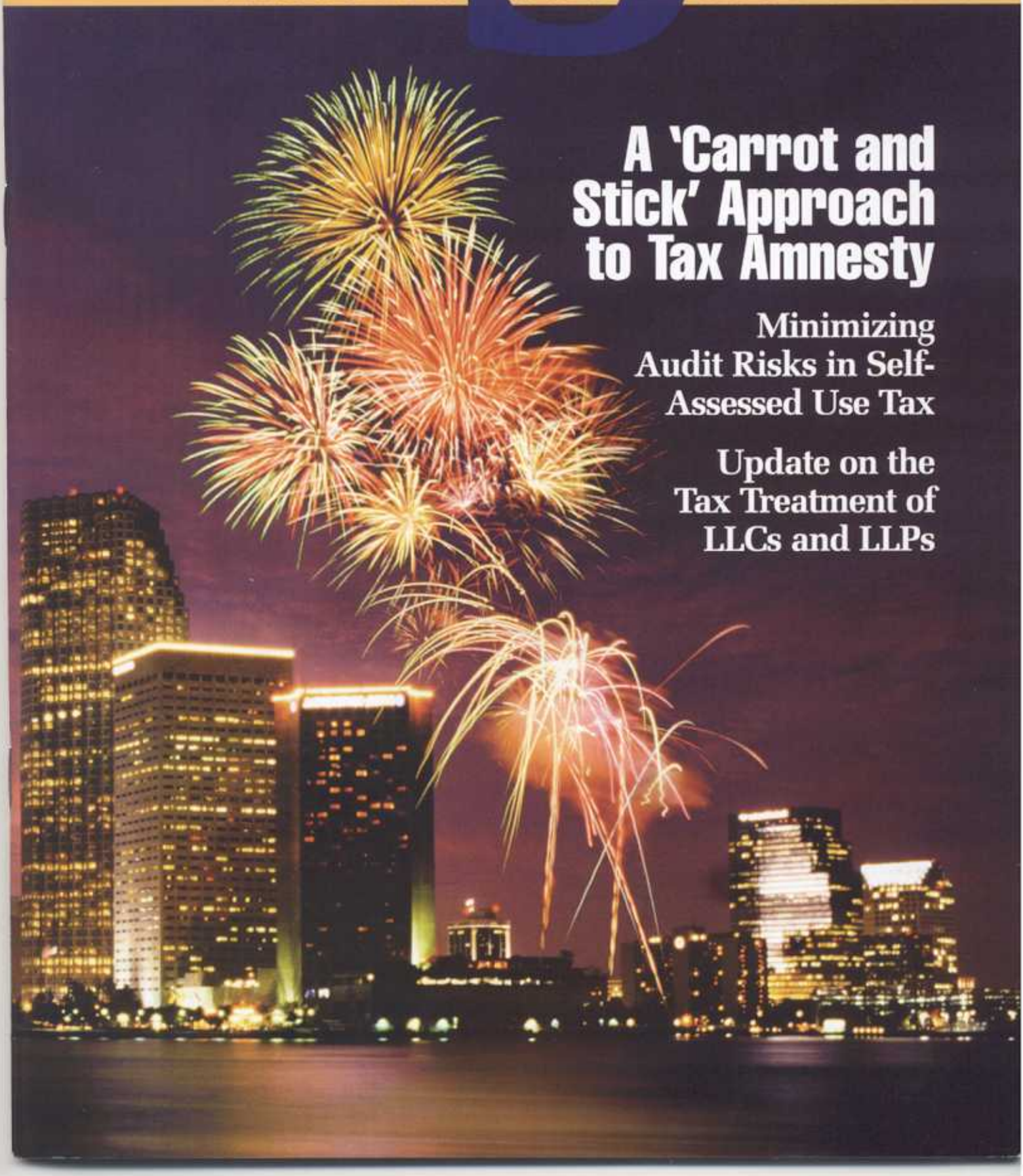
Multi State

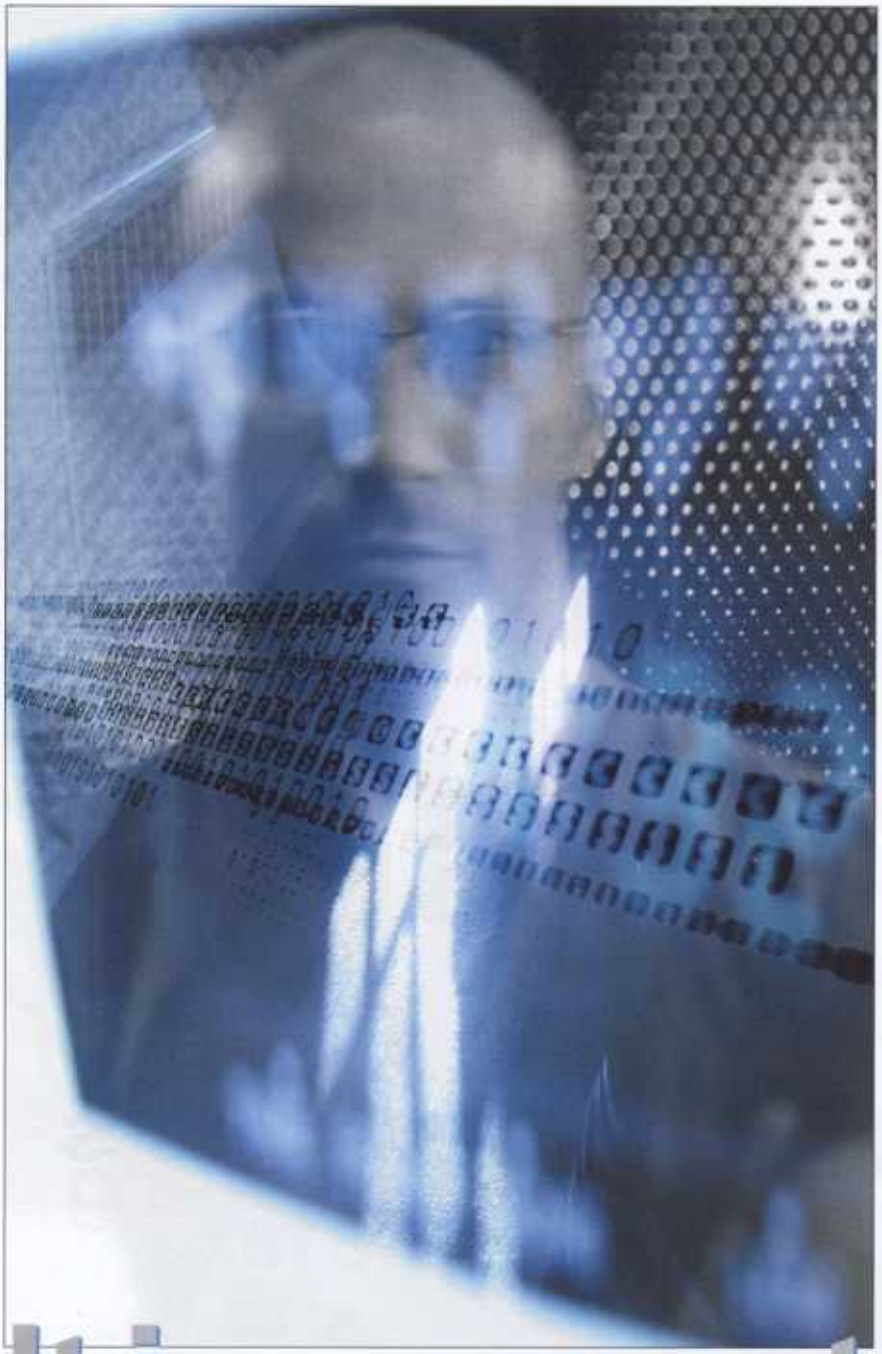
TAXATION AND INCENTIVES



A 'Carrot and Stick' Approach to Tax Amnesty

Minimizing Audit Risks in Self-Assessed Use Tax

Update on the Tax Treatment of LLCs and LLPs



It is no secret

that state budgets are under enormous pressure these days. National as well as global events have tightened federal purse strings, resulting in less funding to states for critical public services including education, safety, and public works. In the boom times of the late 1990s, these issues would have been fairly easy to resolve. Revenues from all tax sources were growing, investment assets in pension plans and other vehicles were returning double-digit growth, and consequently the states' rainy day coffers were well funded. In that heady environment, states were in a position to help themselves and, ultimately, their constituents.

A fast-forward to the 21st Century, however, portrays a very different picture. The recent recession has turned states' budget surpluses into deficits, threatening the delivery of essential services to their constituents. According to one report released by the National Conference of State Legislatures, approximately 30 states noted that revenue collections are below budget forecasts. Twenty-four states reported that either the governor or a member of the legislature has proposed tax increases.[1]

Personal and corporate income taxes as well as sales taxes are the most likely targets for these increases, simply because they represent the largest revenue sources for the states. The most popular increases under consideration are the "sin" taxes on both alcohol and cigarettes, with at least 14 states considering raising taxes on these items. Additionally, six state officers indicated that a general sales tax rate increase or base expansion is possible, while four said that increases in personal income tax are under consideration.[2]

Reductions in services are certainly in the plans for all states as well. While the remedies to the problem may vary, the states' predicament is clear. Revenues must be raised from existing sources or essential services will be curtailed.

The Growing Role of Use Taxes

Ever since the first sales tax was imposed in 1930, questions arose concerning the states' authority to tax interstate transactions. Use taxes that mirror the in-state sales tax were imposed to deal with the taxation of interstate sales made by out-of-state vendors. While the goal of the use tax was to broaden a state's overall tax base, the business environment in those early days rendered this levy as fairly insignificant, compared to the sales tax.

The national and global reach that exists in commerce today was not prevalent 30 or even 20 years ago. Back then, businesses typically purchased goods from vendors within their locality. Sales taxes (assessed on intrastate transactions) were charged on the sale of taxable goods and services and collected by the vendor, who reported the liability and remitted the collected tax to the appropriate jurisdiction. As

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transportation networks improved and business logistics became a mainstream function of industry, the vendor pool became regional and ultimately national in scope. The era of nationwide next-day and even same-day delivery had arrived. An increased choice of vendors was available to businesses and individual consumers alike, pushing prices down, to the ultimate benefit of all in the supply chain as evidenced by the post-World War II economic boom.

As commerce moved across state lines, the determination of when a taxpayer was liable for the sales tax became cloudy and more difficult to regulate and enforce. Clearly, where a sales tax was imposed, the ultimate consumer (either business or individual) was responsible for paying the tax on the purchase; the obligation for assessing and collecting the tax, however, posed some problems.

Nexus and tax collection responsibility. The landmark 1992 U.S. Supreme Court decision in *Quill Corp. v. North Dakota*,[3] attempted to provide some clarity on this issue. The Commerce Clause concept of nexus or physical presence was reinforced to require those vendors that met the profile of an entity engaged in commerce within a particular taxing jurisdiction to assess and collect use tax. Here, nexus is represented by a level of investment in physical assets, employment of a workforce, or degree of commercial activity. Absent the vendor's meeting this physical presence test, the burden of assessment and remittance remained with the end-purchaser who would be required to self-assess and remit "consumer's" use tax to the state where the goods or services would ultimately be used or consumed.

Vendors that fell within the "gray" area of nexus determination generally preferred to take the easy road regarding the responsibility for assessing this transactional tax, and assumed that the end-customer would assess and remit according to the customer's own legal obligation. Self-serving interpretations of the tax laws would ensue between state tax officials and the out-of-state vendors, with the former making a case as to why physical presence was evident (thus, requiring the vendor to assess and collect use tax), and the latter asserting that it was not (leaving it to the customer to self-assess and remit the use tax). Accordingly, it is easy to see where the absence of clear authority to calculate and remit these tax liabilities provided a void that contained a large—although generally difficult to measure—pool of uncalculated and unremitted funds.

In the 'new economy,' and more specifically the Internet, the traditional nexus measurements seem to have become irrelevant.

So, what has changed in the last ten years to bring this issue to a focus? While the transformation from a local to a broader-based economy has had implications regarding who is responsible for assessing and remitting sales/use taxes to the respective states, the transformation has been somewhat orderly. Additionally, physical presence criteria and measurement have remained fairly intact over time. If a vendor meets the physical presence test, then bill, collect, and remit the tax; if not, don't.

Now that the "new economy," and more specifically the Internet, has emerged as an acceptable vehicle for transacting business for both individual consumers and businesses, the traditional nexus measurements seem to have become irrelevant. Does an e-commerce web site hosted by a bank of computer servers located in a remote state, by itself qualify as establishing "physical presence"? Probably not, based on these limited facts. This interpretation of the issue has become core to the arguments made by the states that believe they are losing tax revenues, as well as by traditional brick-and-mortar vendors that claim these "e-tailers" enjoy a competitive pricing advantage equivalent to the sales/use tax obligation that they avoid. While statistics vary, one study estimates that uncollected sales tax from e-commerce and remote sales was more than $13 billion in 2001, and will rise to about $55 billion by 2011.[4]

Current initiatives like the Streamlined Sales Tax Project (SSTP), as well as recent state challenges to the status of out-of-state vendors, may ultimately resolve questions regarding the sales tax collection obligations of remote vendors.[5] In addition, pressure for Congress to legislatively overturn *Quill* may gain momentum as the budget and tax-collection issues facing the states today will require them to explore avenues that will generate additional sales and use tax revenues—such as via audits.

Self-assessed use tax is one area in which the states would likely focus their attention. Accordingly, businesses should be prepared to prioritize their determination of this self-assessed levy and, to the greatest degree possible, take advantage of the emerging automation tools that are available to render these tax calculations as a routine and complementary function of their core business processes.

The following discussion looks at the common areas of self-assessed use tax compliance, the underlying difficulties of that compliance, and the potential to automate routine aspects of use tax self-assessment and remittance functions through a company's "enterprise resource planning" (ERP) system or its financial applications.

Traditional Difficulties of Self-Assessed Use Tax Compliance

A compliance study issued by the Washington State Department of Revenue asserted that Washington businesses failed to pay 27.9% of use taxes due on out-of-state purchases, costing state and local governments more than $100 million annually.[6] Accounting errors were the most common reason for noncompliance, occurring 56.9% of the time. Ignorance of the statute accounted for 21.6% of noncompliance, differences of opinion for 15.7%, and negligence or fraud for 5.7%. These statistics support the common perceptions that difficulties compiling the underlying data, as well as the lack of a clear understand-

ing of the applicable taxability of these transactions, are the most common causes of noncompliance.

The compliance difficulties encountered are most commonly associated with routine accounts payable items, expenses that comprise the majority of the purchases that support the day-to-day operations of business. Nevertheless, other areas of use tax liability also pose similar accounting difficulties; for example, recognizing tax liabilities for inventory removal as well as asset movement transactions.

Categories for Self-Assessed Use Tax

A typical business will encounter three primary sources for self-assessed use tax liability:

- General purchases through the accounts payable process.
- Fixed asset transfers (interstate and intercompany).
- Inventory removal transactions—goods converted from exempt to taxable use.

General purchases. Every business establishes relationships with vendors who will supply the critical goods and services the business needs in order to produce goods or services to sell to customers at a profit. The items purchased can take many forms including raw materials that will be converted to finished goods, routine office supplies for the office staff, as well as services such as office cleaning and professional services. When a purchase qualifies for an exemption or is otherwise nontaxable, typically the buyer will provide an exemption certificate instructing the vendor not to charge tax.

Generally, items that are purchased for eventual resale (notably, inventory) are exempt from taxation. In addition, different jurisdictions provide for specific categories of goods and services that may qualify for a sales/use tax exemption. It is incumbent on the buyer to know which purchases are exempt in particular jurisdictions and inform the vendor accordingly (through issuance of an exemption certificate or some other acceptable method). In these situations, the buyer must have access to (or be in a position to pay for) the requisite tax research in order to make an informed taxability decision. This research material, often summarized in complex tax matrices, must be continuously maintained, given the constantly changing tax laws.

From a user/consumer perspective, the ultimate use of the goods or services typically dictates the taxability of the purchase. For example, items are almost always tax-exempt when purchased directly for remanufacture into another good, with the ultimate purpose of being sold in the normal course of business. The actual physical make-up of these items has no bearing on their taxability. In other instances, goods or services are exempt by statute because of their unique characteristics. One example is legal services, which typically are exempt from taxation, as opposed to the trend to tax information-technology consulting services. The taxpayer must be able to view taxability from both perspectives—the "how" and the "what"—in order to properly reflect the correct tax on a purchase.

Other considerations. *Quill* directly addressed the tax collection and remittance obligations of out-of-state vendors that met the physical presence or nexus tests. Although these concepts appear quite simple, compliance on both ends of the transaction can prove rather difficult. Many vendors are only able to treat a customer's purchases as exempt or taxable in totality. Customers buying a variety of merchandise that falls under taxable and nontaxable scenarios are forced to unwind the improperly determined amounts through both the debit and credit sides of their tax accrual general ledger accounts, or by filing tax refund requests directly to the jurisdictions. Consider also the following:

Direct pay permits. More than 35 states now grant "direct pay permits," which allow the consumer to remit sales/use tax directly to the taxing authority rather than having the vendor collect the tax. This approach places the calculation and remittance burden directly on the consumer of the goods and services, who thus buys "tax free" from all vendors in a particular jurisdiction. The buyer, generally better informed to make the proper tax determination, must then be prepared to do so in all cases.

Managed compliance agreements. A "managed compliance agreement," often entered into in conjunction with a direct pay permit, allows a business to apply a blended tax rate on all agreed-upon purchase categories, calculating and remitting the tax directly. For example, a manufacturer that purchases a variety of clearly nontaxable items (raw materials), taxable items (office supplies), and other items that are somewhere in between (e.g., indirect factory-overhead-type expenses), may negotiate a single blended tax rate on all non-inventory purchases that will be lower than the standard tax rate but will apply to all non-inventory purchases. This self-assessed and remitted levy relieves the taxpayer of the need to review all of its purchases in order to determine when to accrue a tax (or perhaps identify an overpayment).[7]

Self-assessed use tax is one area in which states seeking additional revenues will likely focus their attention.

Evaluated receipts settlement. The increasingly popular "evaluated receipts settlement" (ERS) procedure is a formal agreement between buyer and seller that places directly on the buyer the calculation burden for not only the sales/use tax but also the purchase itself. The seller does not issue an invoice. Rather, the buyer relies on preestablished terms (presented in a purchase order or similar agreement) to calculate its obligations and remit payment directly to the seller, based on the acceptance of goods or services delivered. Up-to-date knowledge of the seller's tax status (i.e., where it has nexus) must be maintained by the buyer in order to assess the proper tax (sales or use) at the proper rate.

Fixed asset transfers. Transfers or other movement of fixed assets (e.g., machinery and office equipment) either across county or state boundaries or between legal entities (regardless of a change of venue) can have sales tax consequences, even if tax was paid on the asset's original purchase. Differences in applicable sales and use tax rates (for example, when the jurisdiction to which the asset is moved imposes tax at a higher rate than in the jurisdiction where the tax originally was assessed and paid) also can create tax obligations.

Other complicating factors include calculating the taxable basis of a depreciated asset that has been moved, or determining whether the transaction was a sale or just a temporary transfer or whether the purpose or use of the transferred asset has changed. These are just some of the many questions that must be considered in order to evaluate the proper tax treatment of transferred assets.

Removal of items from inventory. The direct costs (and some indirect costs) incurred to produce goods intended for sale are typically exempt from sales tax across all jurisdictions. Occasionally, however, a business will remove goods from inventory and use them for its own internal purposes, or a withdrawn item may be redirected to another purpose such as a donation to a charitable cause. In either case, the tax implications must be examined under the laws of the particular jurisdiction involved. Consider, for example, a furniture manufacturer that equips its chief executive's office with its own goods held for resale. Removing such items from the stock of finished goods, assembled with components parts initially purchased "tax free," will usually trigger a taxable event. Other, not-so-clear examples of inventory conversion that should be examined for possible tax consequences include using items as product samples for distribution to potential customers at trade shows or through direct-mail promotions.

In addition, some states recognize a treatment different from the standard

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1 Hubbard, "States Face Growing Budget Gaps, Half Eyeing Tax Increases," The SOHO Daily News on the Web, available online at www.toolkit.cch.com/columns/taxes/03-330statetax.asp. SOHO America offers an online, virtual community for small-office/home-office professionals, providing reference tools and technical support, the latest news affecting small and home offices, access to expert advice, and a forum to network and exchange ideas. Additional information on the National Conference of State Legislatures' report may be obtained from the organization's website, www.ncsl.org.

2 *Id.*

3 504 U.S. 298 (1992). See generally Eule and Richman, "Out-of-State Mail-Order Vendors Need Not Collect Use Taxes—Yet!," 2 JMT 183 (Sep/Oct 1992). See also Nolan, "Crossing the Bright Line: Evaluating Physical Presence in *Quill*'s Shadow," 7 JMT 244 (Jan/Feb 1998).

4 "New Study Shows Sales Tax Revenue Losses From E-Commerce 41 Percent Higher Than Previous Estimates; States, Localities Projected to Lose $54.8 Billion a Year by 2011," Institute for State Studies, available online at the Institute's website, www.statestudies.org/news1.html. The ISS, based at Western Governors University, Salt Lake City, Utah, is a nonprofit foundation devoted to developing strategies to resolve public policy dilemmas resulting from new technology.

5 See Edwards, "Streamlined Sales Tax Project Seeks to Expand Collection of Tax by Remote Vendors," 11 JMT 6 (August 2001). For an update on states' participation in the SSTP, see DiBello, "The Changing Sales Tax Regime: Kansas Seeks to Adapt to the Streamlined Sales Tax Project," 14 JMT 28 (May 2004).

6 "Washington State Study Shows Sharp Drop in Use Tax Compliance," Vancouver Bus. J. (2/14/03), available online at www.vbjusa.com/vbj/index.cfm?page_editorial_id=26925.

7 For more on this practice, see, e.g., Gavin and Wyeth, "Connecticut's Innovative Managed Compliance Program Benefits Taxpayers and the State," 10 JMT 14 (August 2000).

Transfers of fixed assets between legal entities can have sales tax consequences, even if tax was paid on the original purchase.

taxability, when the transaction is deemed an occasional sale. As is the case with fixed asset transfers, determining taxable basis can vary from state to state, taking into consideration, e.g., fully loaded costs, retail selling price, net realizable value, or other method.

ERP Systems

Managing a successful business requires the ability to make timely decisions based on accurate information. This obvious statement would apply to all businesses with an emphasis on the concept of time. Today's market leaders no longer have the luxury of time to correct mistakes. Guessing incorrectly on proper inventory levels, overcharging customers, or shipping a day late can ruin a company's reputation that may have been earned over many decades.

Complexity defines the many interrelationships that a business entity's various segments have with each other. All functional areas of a business must be in synch in order to ultimately earn a customer's loyalty. These complexities could be minimized if each functional area, including production, finance, sales, and marketing, could share common sets of data, configurable at the user's request, that impact each user's workload. A single sales order affects all areas of a business, including production, billing, purchasing and accounts payable, sales commissions and payroll, income tax calculations, human resource staffing levels, marketing program evaluations, financial forecasts and budgeting, cash management, and a host of other business "touch points."

Traditionally, all areas worked independently with their own data sources. If anything went wrong in the process, tracking down the original source of an error was often difficult. Wouldn't an enterprise want to provide each of its decision-makers with all the data needed to carry out their responsibilities? While the answer appears obvious, the evolution of the "relational database" is a fairly recent development. First developed by IBM in the 1970s, the concept of relational databases refers to a shared connection to common sets of data. Seizing on the power of this tool, many of today's successful software vendors (as well as many that are no longer in business) developed complex applications—known as "enterprise resource planning" (ERP) solutions—that spanned an entity's many functional areas. These proprietary systems attempted to tightly integrate the needs of all users of data including not only company personnel but vendors, customers, and other third parties as well.

How does ERP work? ERP refers to the use of software to automate and coordinate the critical activities that a business must manage, including, for example, finance, customer service, inventory control, interacting with suppliers, and tracking orders. The data from those different areas are stored in a single database, accessible by all departments in order to serve their particular needs.

Events that traditionally took place in a specific area of a company no longer need to remain isolated. Now, for example, sales order entry activities directly impact the ordering patterns of the purchasing department, which will have to account for supplier lead times in order to ensure that the proper inventory levels are maintained for production. In turn, production data will flow back to purchasing, finance, payroll, and other departments so that those areas may properly plan and perform their core responsibilities. So, where does this procedure leave the tax function?

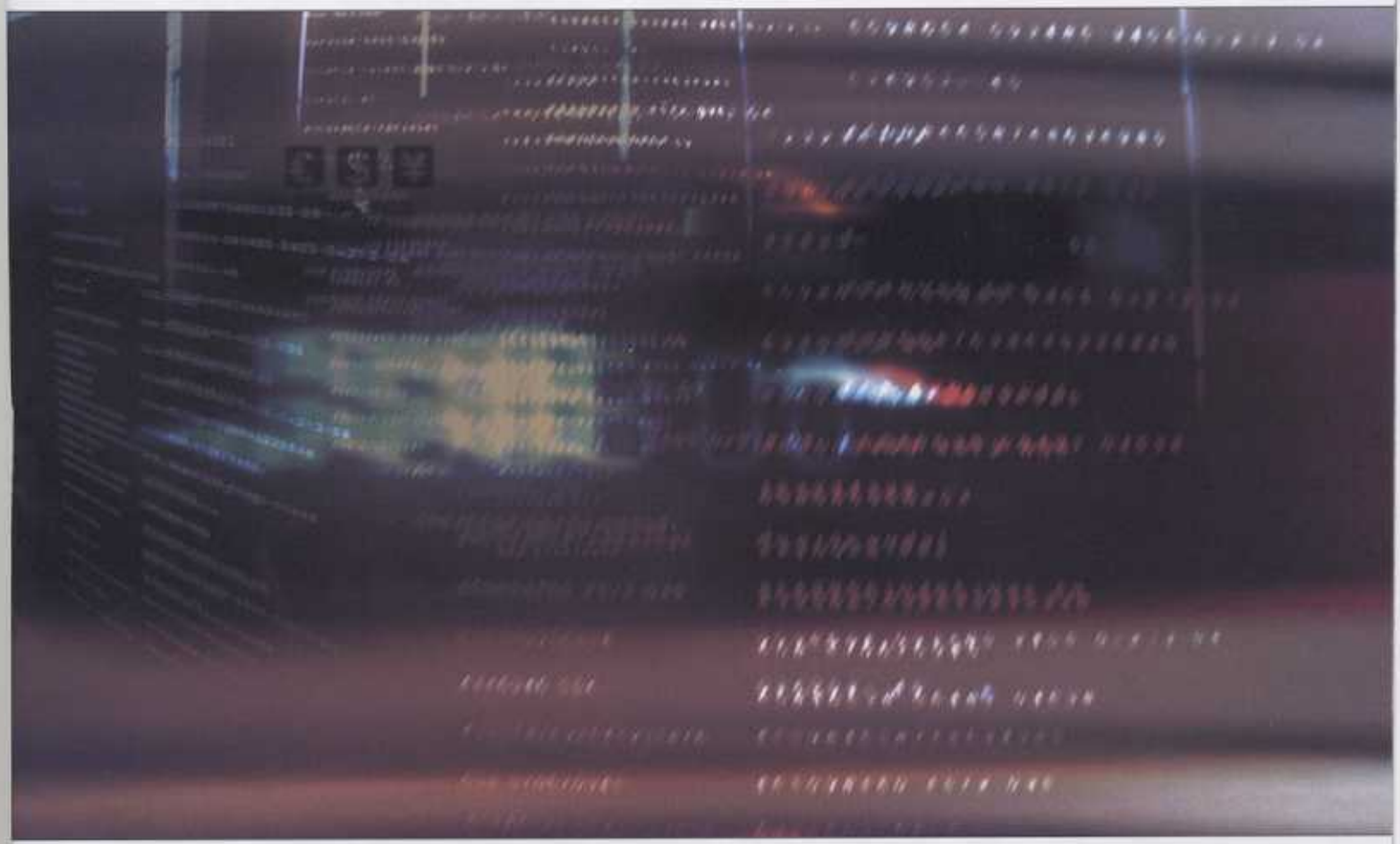
Technology and Self-Assessed Use Tax

Data availability is the common thread of an ERP solution. Access to critical data (i.e., the information required to respond to the events that are most closely associated with the revenue cycle of a business) has received, and always will receive, the highest priority within an organization. The sales tax calculation can be viewed as a critical component of the revenue cycle since the tax ultimately appears on a customer's invoice. If tax is not properly determined, the customer could withhold payment or request a sales credit. Accordingly, order entry, credit, and billing systems have been implemented to properly reflect an accurate sales tax calculation.

The self-assessed use tax calculation should also take advantage of the automation tools available, in order to minimize tax liability and overall audit exposure, and ultimately improve the company's bottom line. While sales tax is a pass-through item (the levy is collected on behalf of, and remitted directly to, the taxing jurisdiction), true expense management can be realized from effective use tax calculation and compliance.

For any corporate tax department that has suffered through the pain of a sales/use tax audit and an assessment attributable to the business's own unreported use tax liabilities, this topic is not new. Why then was it not until just recently that automation tools were developed to handle this common and routine tax function? There are many reasons, depending on the organization itself and the industry niche in which it operates. Manufacturers, by their very nature, are subject to almost all areas of a state's sales and use tax statute that narrowly defines taxable and nontaxable events and circumstances. With 46 different state tax codes (one for each state imposing sales and use tax) and literally thousands of county and district taxing jurisdictions, the result is a maze of tax rules, regulations, and interpretations that a company's tax or finance department must navigate in order to understand the implications and their relevance to any of the activities noted above that potentially can give rise to a use tax liability.

Applying the taxability rules to the literally thousands of purchasing decisions a business undertakes is not a simple task. Centralized purchasing functions that adhere to policies requiring the advance preparation of purchase orders that reflect the presumed



taxability of a purchase is a step in the right direction, but much of the burden is still left to individuals who may not prioritize or understand the tax function. Exemption certificates may have been issued to vendors at some point, but do the same buying conditions still apply and are they relevant to the taxability of a transaction today?

In decentralized purchasing environments, tax determination is typically a secondary responsibility of the buyer who is primarily concerned with ensuring an orderly flow of goods and services to keep the buyer's area—or, in some cases, the entire business—running smoothly. Many organizations rely on the accounting department to review processed accounts payable transactions in order to determine the proper tax treatment of a particular invoice. Wading through stacks of invoices at month-end is a common task for accounting clerks who attempt to decipher specific line items on an invoice and make a tax determination based on a limited understanding of the nature of the purchase. These after-the-fact processes are time consuming and prone to errors. Use tax liabilities that arise from fixed-asset movement or inventory conversion transactions often go unreported by an entity and are uncovered only during an audit, accompanied by both penalty and interest assessments.

Technology's role. Clearly, today's technologies can improve a business's ability to recognize self-assessed use tax liability, as well as use tax overpayments. While ERP systems permit data to be warehoused and accessed by many different users for many different purposes, this same data can be accessed to standardize the routine calculation and verification of liability in transactions giving rise to self-assessed use tax. Most of today's sales tax software vendors are able to calculate an accurate sales tax when goods are sold to customers. Tax logic can be configured to recognize customer-provided product exemptions (e.g., specific part numbers or "stock-keeping units" (SKUs) supported by a valid exemption certificate) in particular jurisdictions. Similarly, the data warehouse makes it possible to provide all of the data elements necessary to make a self-assessed use tax calculation on a purchase just as simple as a sales transaction. Purchase transaction details passed from an ERP or homegrown financial application to third-party tax calculation software can include enough identifying data elements to make rational and routine tax determinations.

These data elements can include a variety of identifiers, including general ledger account numbers, project numbers, vendor IDs, or internal usage codes. The third-party tax software applications can be configured to return a desired tax result when elements of any of these pieces of data are introduced into a tax calculation engine. Jurisdiction identifiers (ZIP codes, "GeoCodes," etc.) can be matched with the specific transaction to return the desired calculation that can be either accrued or reconciled to a tax billed by a vendor.

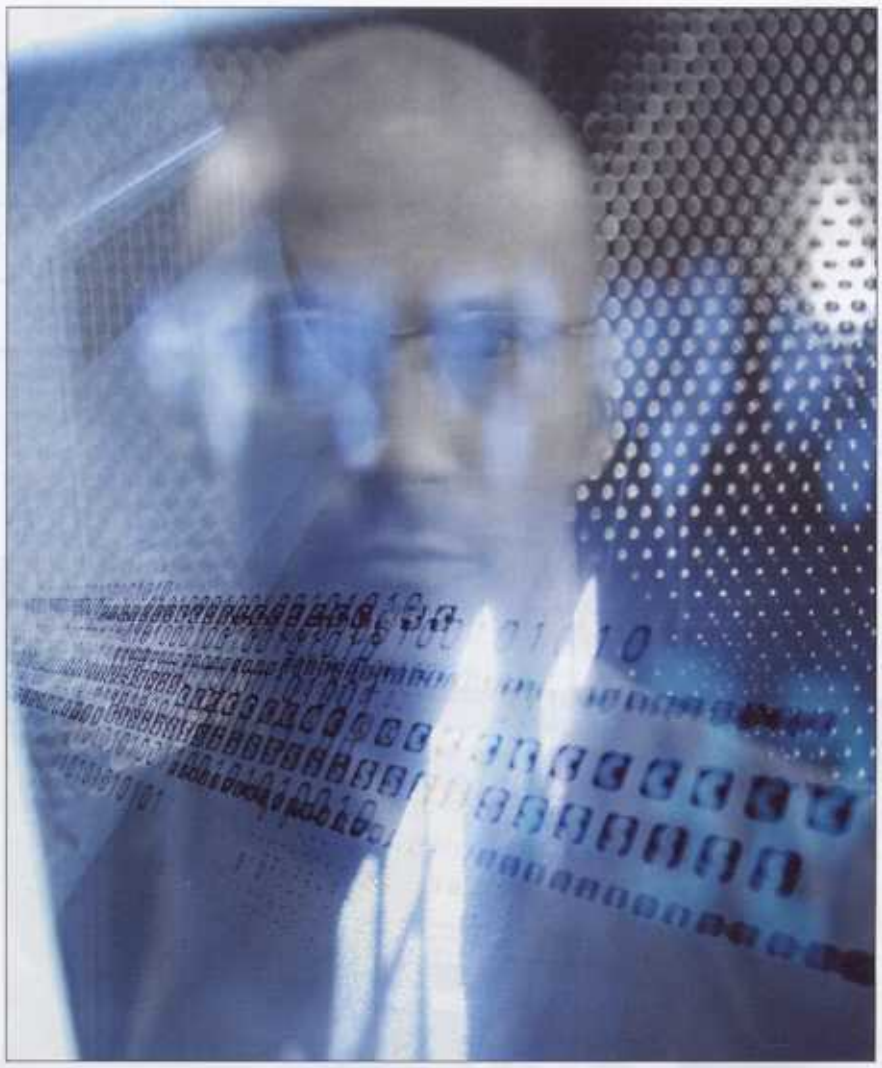
Similarly, events occurring outside the traditional core financial applications (such as inventory withdrawals or fixed asset movements) now carry their own unique *(Continued on page 48)*

(Continued from page 19) identifiers within the ERP that no longer have to remain behind the four walls of these applications. Inventories can be relieved from a company's books and records in a number of different ways. In a typical sales transaction, a reduction in perpetual inventory records is triggered by a billing transaction (creating an invoice) with a customer. Both sales, including any sales tax receivables, and cost of sales are recognized when this event occurs. When, for example, inventories were relieved to provide samples for trade shows, however, the historical financial treatment was to recognize shrinkage from inventory whenever the periodic physical inventories were taken. Current ERP disciplines require that consumption records be created by those responsible, in order to properly report on these nonroutine consumptions.

Better recordkeeping provides better data to manage a business, and these improved tools make the recognition of self-assessed use tax possible. When the consumptions are recognized, they can be routed to the tax calculation software in the same manner as a normal accounts payable transaction that will then be evaluated based on the preassigned parameters established by the taxpayer. Because these transactions by their nature are not routine, and thus might be misinterpreted to result in an erroneously large tax liability, they can alternatively be routed to the company's tax department for evaluation *before* a tax is calculated and accrued.

Conclusion

The error-prone and time-consuming manual processes that have defined an organization's self-assessed use tax activities can now be replaced by the automation tools that are present in most current financial applications that integrate with state-of-the-art third-party sales and use tax software. Those third-party packages that provide tax research support along with data element mapping and configuration abilities, offer powerful tools that aid an organization's tax department.



Employing a systematic approach will improve morale and performance of over-burdened accounting and tax professionals who can now focus on more fulfilling and productive activities. In addition, a systematic and automated approach to self-assessed use tax will provide a taxability blueprint that a state or local tax auditor can use before the detailed audit fieldwork starts, in order to evaluate the overall accuracy of the methodology behind the system and, it is hoped, reduce the scope of the audit itself. The company's tax department will have the tools to make the proper taxability decisions before transactions are actually processed, with the desired outcome of paying the proper tax (i.e., neither too little nor too much) without associated audit penalty and interest assessments.

ERP software vendors have recognized that the proprietary systems that used to characterize installations in the 1990s have given way to open architecture and design. The costs to implement these complicated systems will be reduced through new technologies, including such computer programming languages as JAVA and XML, allowing disparate financial systems to communicate across hardware and software/operating system platforms. Similarly, integrating to third-party add-on software packages, including sales and use tax, will be simplified through the use of these available technologies. The successful business must be able to evaluate the long- and short-term capabilities of these software vendors, based not only on their vision, but their track record of performance, support, and reliability. ■