

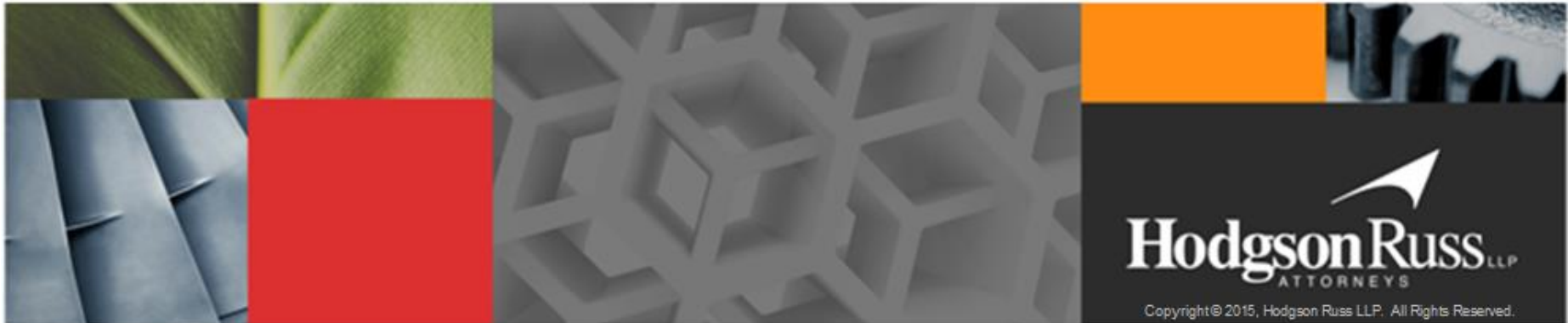
Multistate Taxation of Service Providers



Presented by

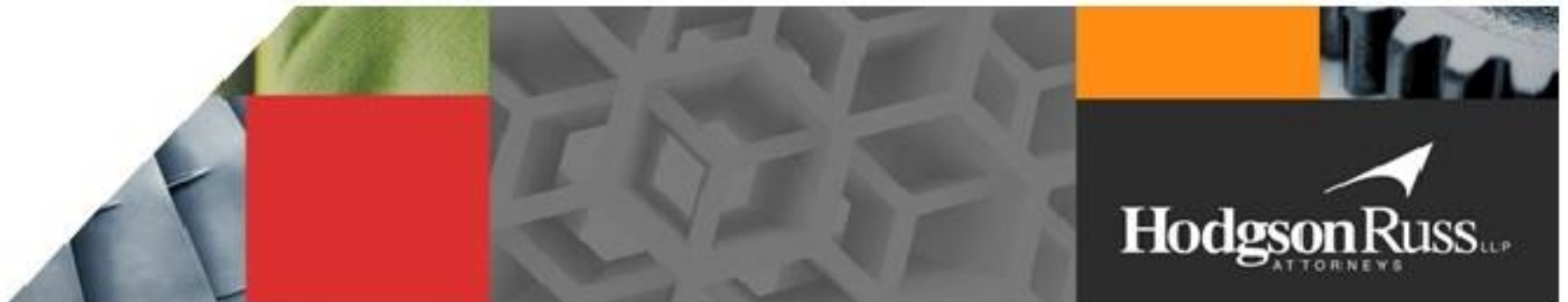
Timothy P. Noonan, Esq.

August 27, 2015



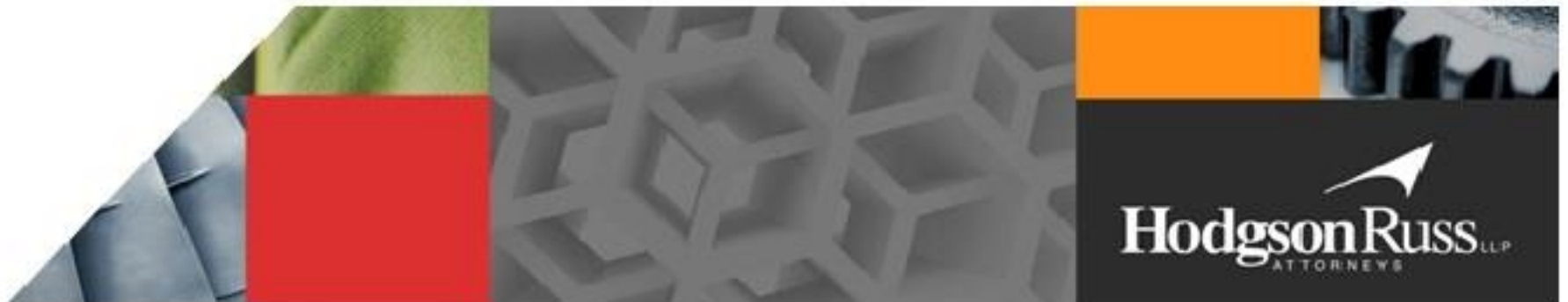
Introduction

- 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

The Commerce Clause

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

But ...
does it apply
to income
taxes?



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
 - Traveling Roadshow



Real World Scenario

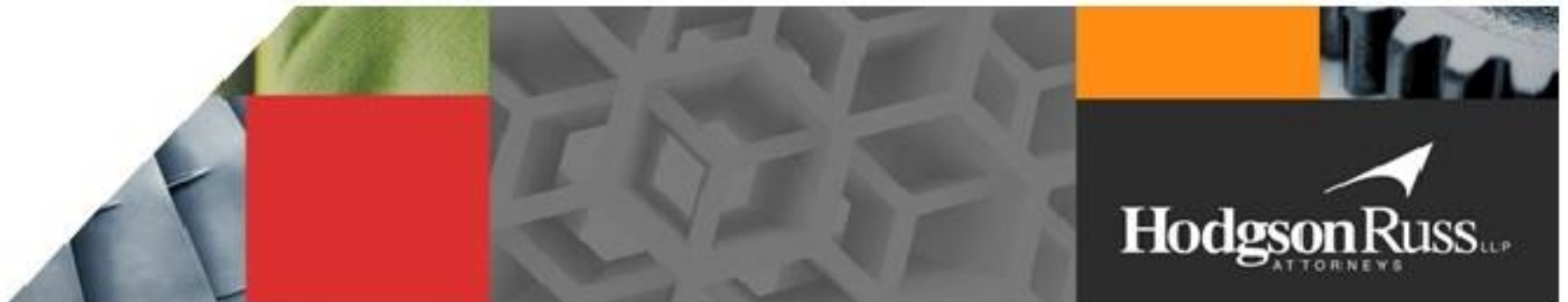
- Minnesota Department of Revenue “Sting”
 - 2013 Operation
 - Targeting large law firms
 - Found the firms by reviewing 1099s issued by Minnesota based companies
 - Seeking 2005-2011 taxes
 - MN agreed in most cases to three-year look-back and no penalties
 - *Hodgson Russ v. Minnesota*

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, including NYS

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 passthroughs
 - 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 passthroughs
 - 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 UDIPITA formula 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 intangible 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

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

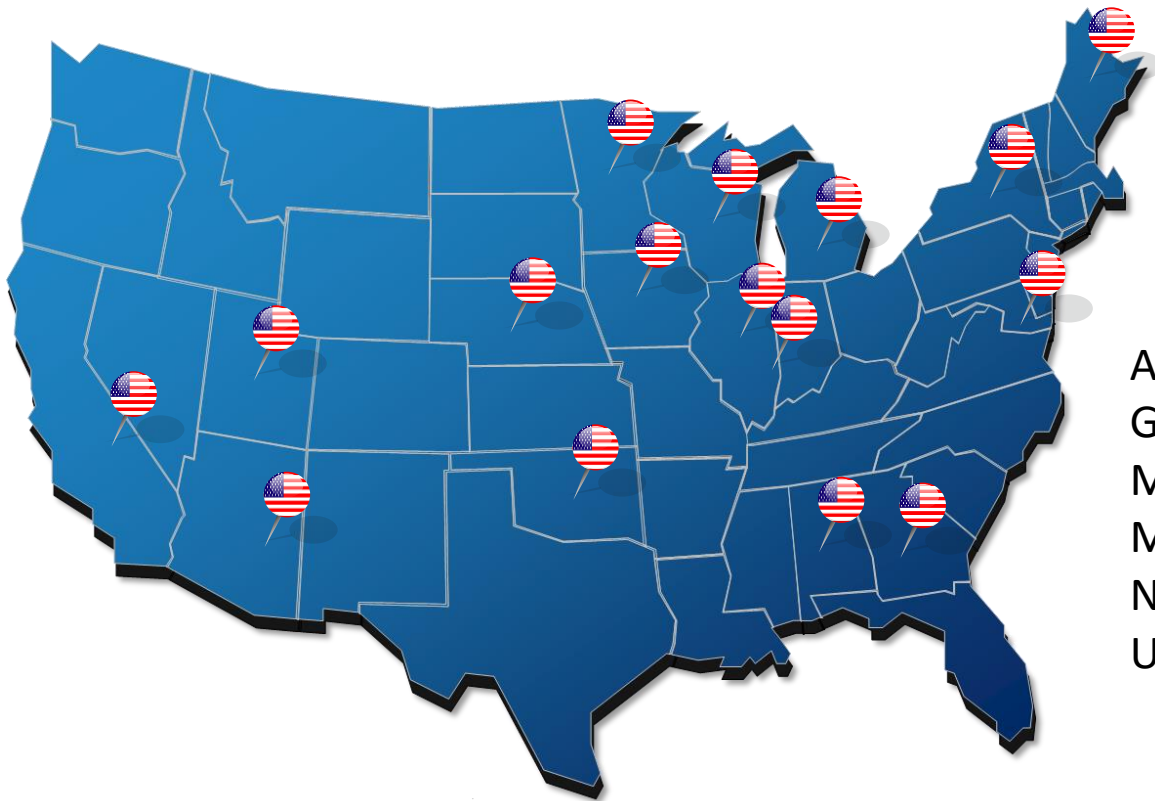
Sales Factor Issues

- 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

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: UDIPITA 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?

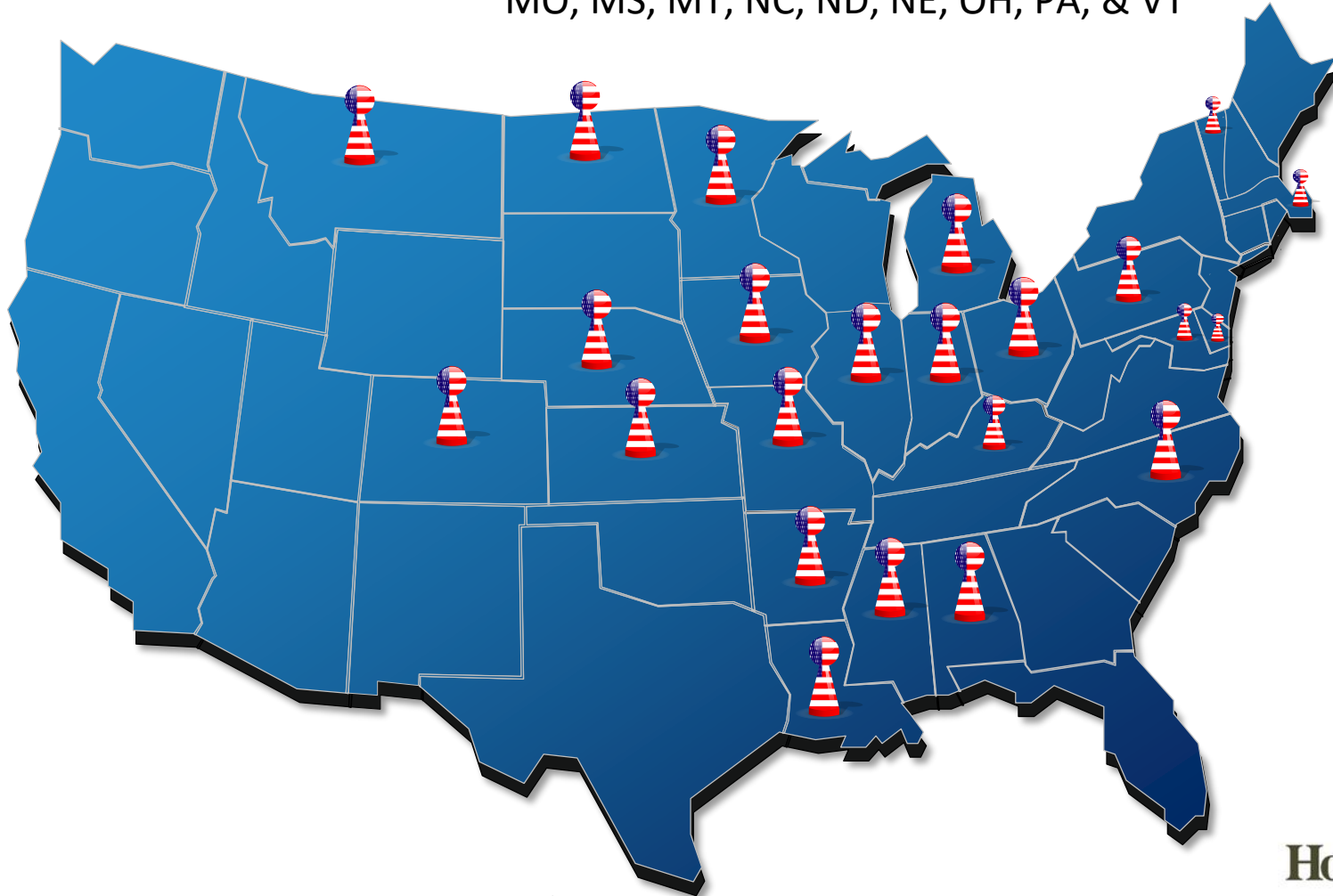
Personal Income Tax Issues

- 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

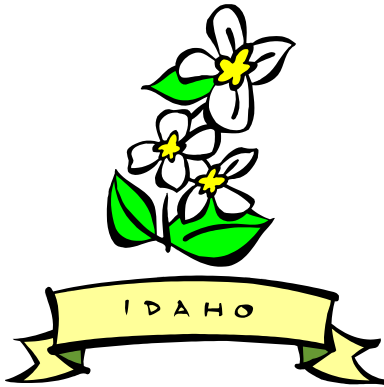
Payroll Withholding

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



Payroll Withholding

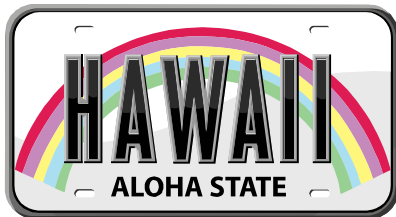
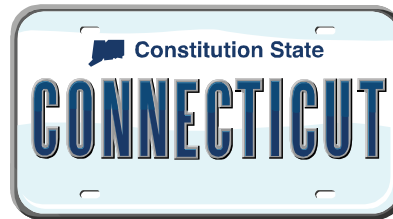


Income Thresholds



Payroll Withholding

Time Thresholds

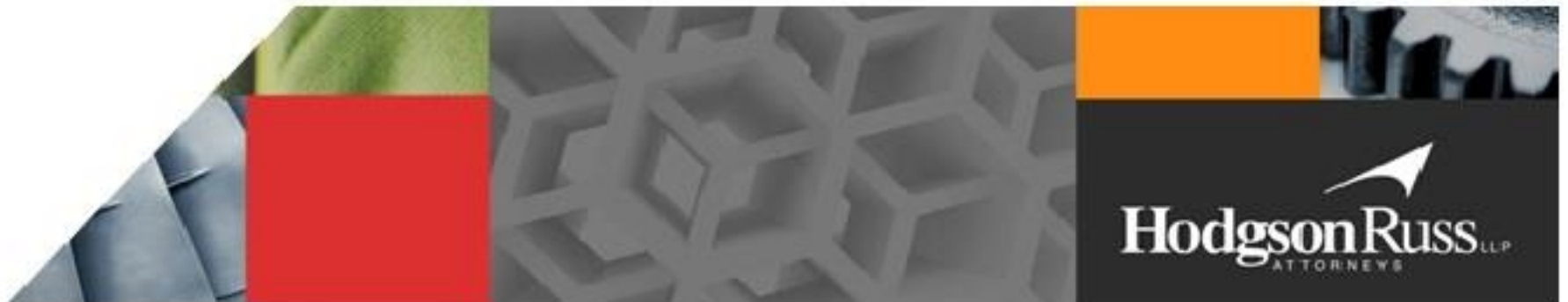


Practical Problems

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

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 property 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!

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





Contact Information

Timothy P. Noonan, Esq.
Hodgson Russ LLP

716.848.1265

tnoonan@hodgsonruss.com

Twitter: @NoonanNotes

