Nexus, Sales Tax, and the Future of P.L. 86-272

Mark S. Klein, Joseph N. Endres, Open Weaver Banks, & Joseph F. Tantillo

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Topics

1. Corporate Income/Franchise Tax Nexus
2. P.L. 86-272
3. Nexus for Pass-Through Entities
4. Sales Tax Nexus
5. Sales Tax – The Nightmare Scenario
6. Sales Tax on SaaS and Other Digital Transactions
7. Audit Targeting and Best Practices

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Corporate Income Tax Nexus

- Each state sets its own nexus standard.
- A state's assertion of income tax nexus over a corporation has to comply with the Due Process and Commerce Clauses of the U.S. Constitution.
- The Constitution requires ***substantial nexus***.
  - Substantial nexus is established when the taxpayer avails itself of the privilege of carrying on business in a jurisdiction.
  - According to *S. Dakota v. Wayfair, Inc.*, 585 U.S. 162 (2018):
    - Economic and virtual contacts are sufficient to create substantial nexus for sellers that deliver more than $100,000 of goods or services to a state or engage in 200 or more separate transactions for the delivery of goods and services into the state on an annual basis.
    - This quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in the state.

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Example of the Evolution of Nexus

- ***Old Physical Presence Nexus***. Original NJ CBT Nexus statute in effect until 2002 recognized nexus for the privilege of: (1) having or exercising a corporate franchise in NJ; (2) doing business in NJ; (3) employing or owning capital or property in NJ; or (4) maintaining an office in NJ.
- ***Economic Presence Nexus***. In 2002, NJ added "deriving receipts" from sources in NJ and "engaging in contacts" within NJ.
- ***Bright Line Nexus***. Effective 2023, NJ ALSO has a bright-line test:
  - NJ source receipts in excess of $100,000 or
  - 200 or more separate transactions delivered to customers in NJ.

Corporate Tax Nexus Trends

- Most states have “economic presence” nexus.
- But not all states have adopted bright-line nexus.
- States with bright-line nexus include New York, California, Connecticut, Texas and Pennsylvania.
- A few states have “factor presence” nexus.
  - 39 Colo. Code Regs. § 22-301(1)(2)(b) - Substantial nexus is established if any of the following thresholds is exceeded during the tax period:
    - (i) a dollar amount of $50,000 of property
    - (ii) a dollar amount of $50,000 of payroll
    - (iii) a dollar amount of $500,000 of sales
    - (iv) twenty-five percent of total property, total payroll or total sales.

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Public Law 86-272 Protections

- P.L. 86-272 prevents states from imposing ***net income taxes*** on businesses whose only activities in the state are the solicitation of ***sales of tangible personal property***.
- Activities entirely ancillary to sales are also ok.
- What P.L. 86-272 does not do:
  - No protection from sales & use tax imposition
  - No protection for corporate taxes not based on net income (such as NJ minimum tax, Texas gross receipts tax, Ohio CAT)
  - No protection for sellers of services
  - No protection for licensing activities

Historic P.L. 86-272 Issues

- Salespeople performing non-sales activities (such as marketing functions or assisting retail customers with displays)
- Backhauling products
- Repairs
- Sale of extended warranty plans
- Offering branded credit cards to customers

MTC Guidance on P.L. 86-272

- In 2021, the Multistate Tax Commission ("MTC") issued revised guidance limiting the protections of P.L. 86-272.
- According to the MTC, "In the decades since P.L. 86-272 was enacted, the way in which interstate business is conducted has changed significantly."
- The MTC's revised guidance focuses on sales conducted via the internet.

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MTC Guidance on P.L. 86-272

- "As a general rule, when a business ***interacts*** with a customer via the business's website or app, the business engages in a business activity within the customer's state."
- "However, when a business presents ***static text or photos*** on its website, that presentation does not in itself constitute a business activity within those states where the business's customers are located."

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MTC Guidance on P.L. 86-272

Protected	Not Protected
The business provides post-sale assistance to in-state customers by posting a list of ***static FAQs*** with answers on the business's website. This posting of the static FAQs does not defeat the business's P.L. 86-272 immunity because it does not constitute a business activity within the customer's state.	The business regularly provides post-sale assistance to in-state customers via either ***electronic chat or email*** that customers initiate by clicking on an icon on the business's website. This in-state business activity defeats the business's P.L. 86-272 immunity in states where the customers are located because it does not constitute, and is not entirely ancillary to, the in-state solicitation of orders for sales of tangible personal property.

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NY Revised P.L. 86-272 Guidance

- 20 NYCRR Section 1-2.10(i)
- Example 10
  - A foreign corporation places Internet “cookies” onto the computers or other electronic devices of its customers. These cookies gather customer search information that will be used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale.
  - Since this activity does not constitute, and is not entirely ancillary to, the solicitation of orders for sales of tangible personal property, the corporation is not exempt from tax under this section.

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NY Revised P.L. 86-272 Guidance

- 20 NYCRR Section 1-2.10(i)
- Example 11
  - The same facts as example 10 except that the cookies gather customer information that is used ***only for purposes entirely ancillary to the solicitation of orders for tangible personal property***, such as: to remember items that customers have placed in their shopping cart during a current web session, to store personal information customers have provided to avoid the need for the customers to re-input the information when they return to the corporation's website, and to remind customers what products they have considered during previous sessions.
  - Since this activity is entirely ancillary to the solicitation of orders for sales of tangible personal property, the corporation is protected by P.L. 86-272.

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NJ Revised P.L. 86-272 Guidance

- T.B. 108(R) (Jan. 2024)
- Some activities that are not protected from taxation:
  - Transmitting code or electronic instructions through the internet to repair or upgrade products as part of a service subscription or as part of a warranty.
  - Placing software or ancillary data (e.g., apps or "Internet cookies") on computers and devices in NJ to gather market or product research that is packaged and sold to databrokers or other third parties.
  - Contracting with in-State customers to stream videos and music to electronic devices.
  - Contracting with in-state customers for subscription services.
  - Inviting and/or accepting applications for employment through an internet-based platform that are specifically targeted to in-State residents or for in-state job positions other than for sales positions.

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NJ S Corporation Hypothetical

- Facts
  - Prior to 2024, S Corp was owned by NJ & NY residents and was a service provider with customers in NJ and 12 other states.
  - Historically, S Corp reported a 100% factor to NJ on its CBT-100S returns and does not file returns in any other states.
  - In 2024, when it has nonresident shareholders for the first time, the owners begin negotiating a sale of S Corp's assets.
- Will S Corp have to report 100% of the gain to NJ?
  - S Corp should have been using a market factor beginning in 2019 – which would have been less than 100% because it has customers in 12 other states.
  - What about the 12 other states where S Corp was not filing returns?

Nexus for Pass-Through Entities

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Clear Nexus Standards? Not So Much.

- No economic nexus thresholds for pass-through entities in many states
- "Doing Business In" Standard
- Physical Presence
- Imputed Nexus?
- Lack of Uniformity

Clear Nexus Standards? Not So Much.

- NY Partnership Return says "every partnership with any income, gain, loss, or deduction from New York State Sources, must file a return…regardless of the amount of its income." *Instructions to Form IT-204*.
- NJ Partnership Return says "Every partnership that has income or loss derived from sources in the State of New Jersey." *Instructions to Form NJ-1065*.
- Colorado says Partnerships are required to file in any year in which they are doing business in Colorado and have substantial nexus. Substantial nexus includes:
  - $50,000 or more of property
  - $50,000 or more of payroll
  - $500,000 or more of sales
  - 25% of total property, total payroll, or total sales. *CO Dep't of Revenue 1 CCR 201-2; CO Regulation § 39-22-301.1*

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Clear Nexus Standards? Not So Much.

- What about guidance for LLCs taxed as partnerships?
- Many states use the "doing business" within the state guidance.
- What is "doing business"?
- Often defined as "any activity meant to generate financial gain or profit."

Uniformity/Clarity in the Future?

- Nexus thresholds assist with compliance
- Fairness issues/constitutional issues arise when there are no clear nexus rules
- Should my partnership really be subject to taxation by a state in which we have no physical presence and generate $10,000 in receipts? $1,000? $100?

2024 -2025 NYS Sales Tax Update

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Sales and Use Tax Nexus

- **Sales Tax Nexus**
  - Sales tax nexus was historically considered to be more narrow than income tax nexus because it required **"Physical Presence."**
    - *Quill v. North Dakota*, 504 U.S. 298 (1992).
  - Did you have any people or property in the state?
    - Offices
    - Employees or independent contractors
    - Inventories or other property
  - De Minimis Standards?

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Sales and Use Tax Nexus

- **Physical Presence Under Attack**
- In *South Dakota v. Wayfair*, the U.S. Supreme Court permitted the possibility that **economic presence** could create sales and use tax nexus.
  - South Dakota Law:
    - $100K in sales of goods or services to SD or
    - 200 or more separate transactions.

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Sales and Use Tax Nexus – Why the Change?

1992

- In 1992, when the last U.S. Supreme Court nexus case was decided (*Quill*), less than 2% of Americans had Internet access.
- In 1992, mail-order sales in the U.S. totaled $180 billion.
- In 1992, it was estimated that the states were losing between $694 million-$3 billion annually in sales tax revenues as a result of the physical presence rule.

TODAY

- Today, over 90% of Americans have access to the Internet.
- In 2017, e-commerce retail sales alone were about $453.5 billion!
- Recently estimated that the physical presence standard causes states to lose between $8-$33 billion every year (DEPENDS WHO YOU ASK).

…"the Court could not have envisioned a world where the world's largest retailer would be a remote seller."

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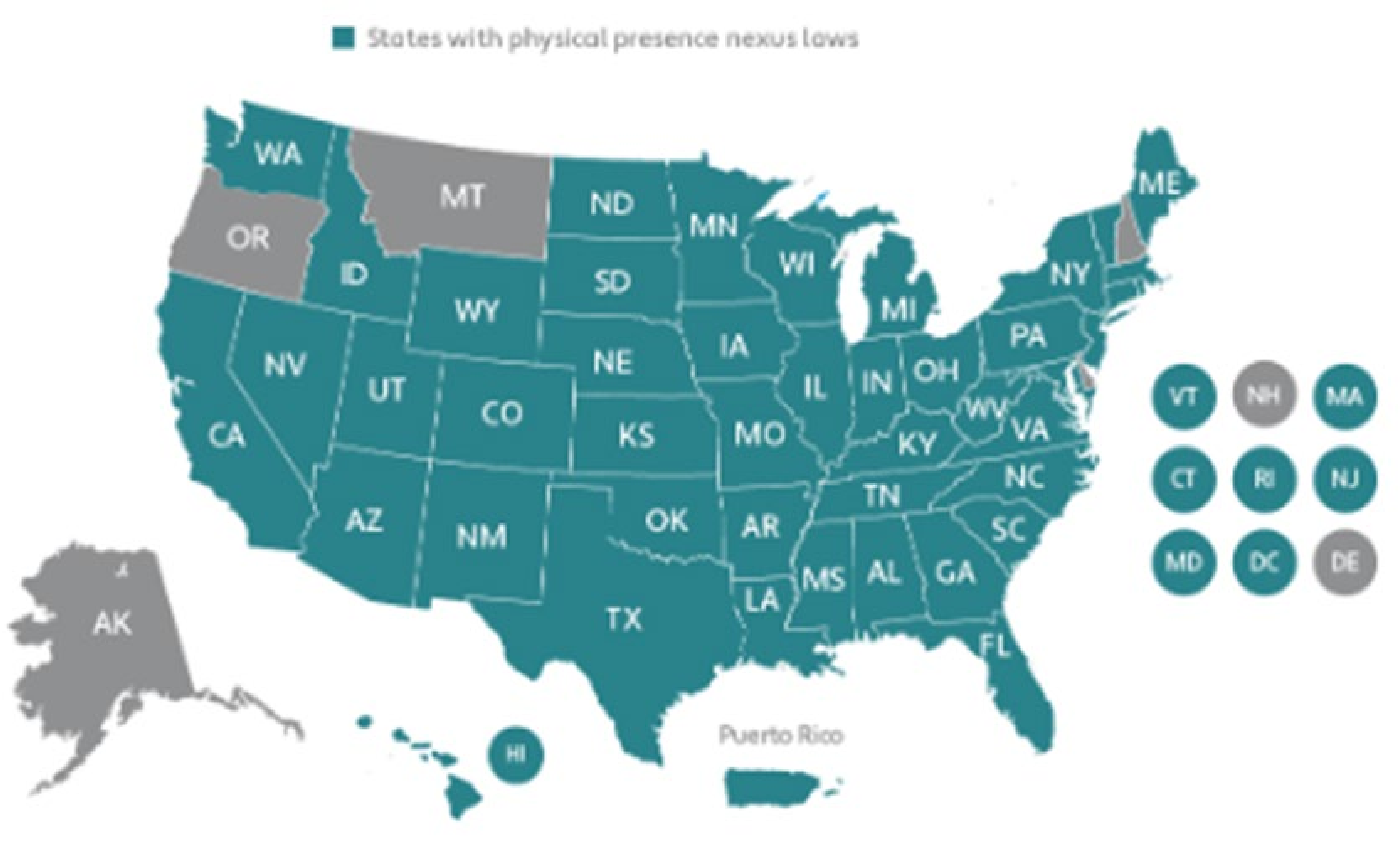
Nexus Expanded!

We went from this:



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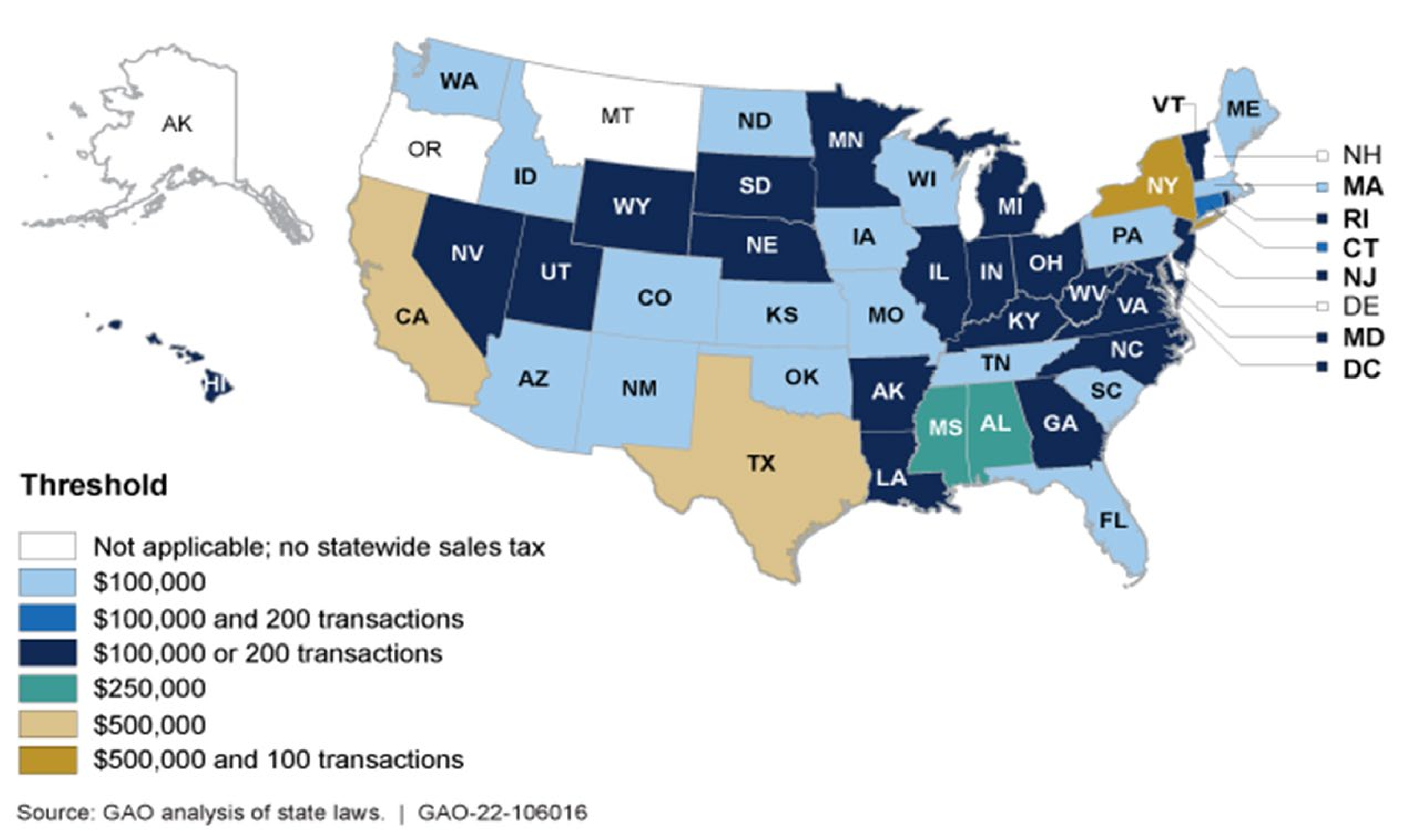
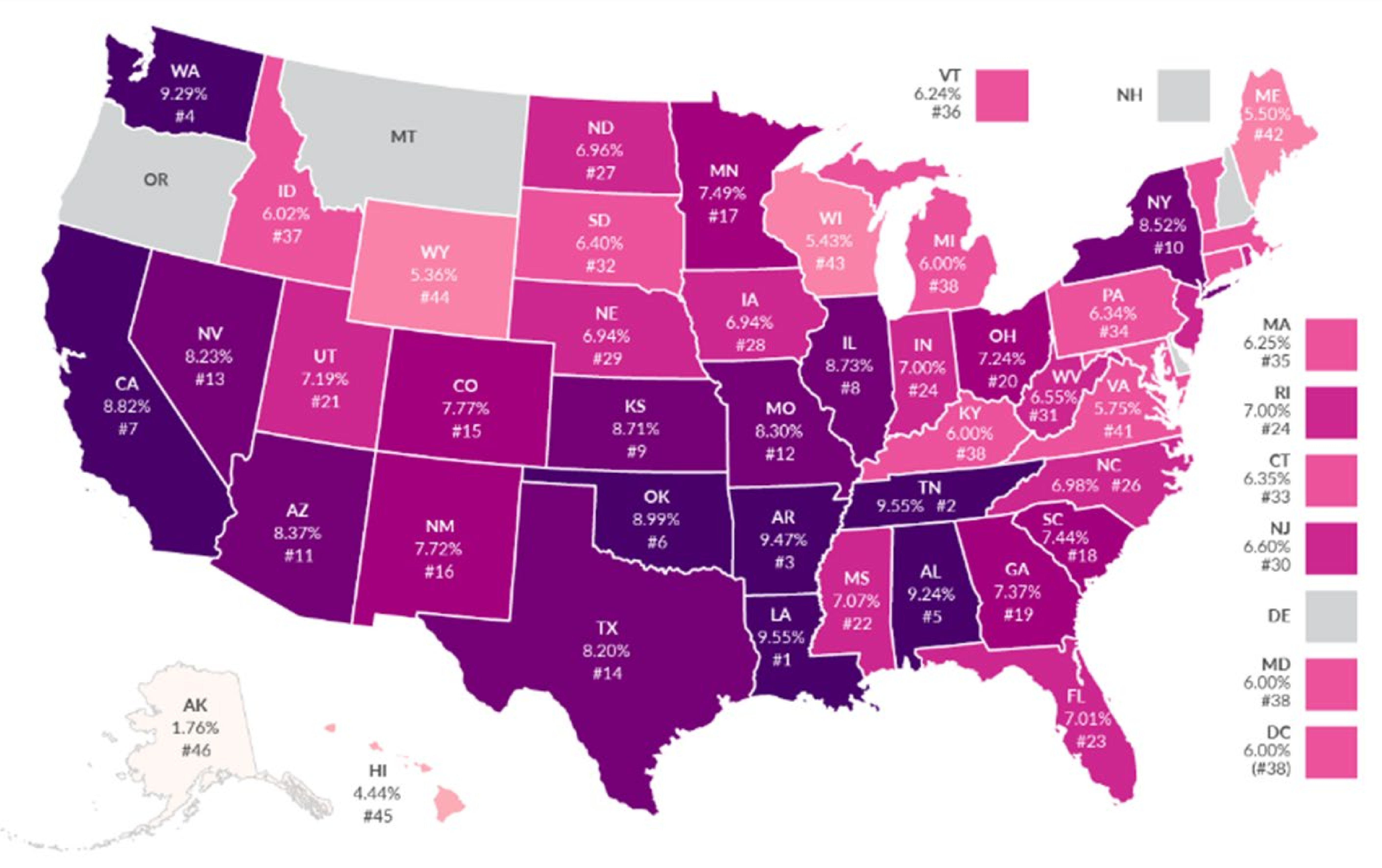
Nexus Expanded!

And moved to this:



Sales and Use Tax Rates



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Is Physical Presence Dead?

- NO!!!
- Economic presence only enters the analysis when the vendor has no physical presence in a state.
- For example, if a business has a salesperson who regularly enters state X, that business will have nexus in state X even if its sales are below state X's thresholds (e.g., sales into the state amount to only $30K)

When Do You Need to Register?

State	When You Need to Register Once You Exceed the Threshold
Alabama	January 1 following the year the threshold is exceeded
Arizona	The seller must obtain a TPT license once the threshold is met and begin remitting the tax on the first day of the month that starts at least thirty days after the threshold is met for the remaining of the current year and the next calendar year.
Arkansas	Next Transaction after meeting the threshold
California	The day you exceed the threshold
Colorado	The first day of the month after the ninetieth day the retailer made retail sales in the current calendar year that exceed $100,000
Connecticut	October 1 of the year in which you cross the threshold on September 30
District of Columbia	Next transaction
Florida	Next transaction (state doesn't specify)
Georgia	Next Transaction after meeting the threshold
Hawaii	The first of the month following when the threshold is met.
Idaho	Next transaction (state doesn't specify)
Illinois	The retailer shall determine on a quarterly basis whether they meet the criteria for the preceding 12-month period
Indiana	Next Transaction after meeting the threshold
Iowa	The first day of the next calendar month that starts at least 30 days from the day the remote seller first exceeded the threshold
Kansas	Next transaction
Kentucky	First of the month following 30 days after the threshold is met (60 days eff. 7/1/2021)
Louisiana	Within 30 days of exceeding the threshold, the remote seller must submit an application to the Louisiana Remote Seller Commission and must begin collecting state and local sales and use tax based upon actual applicable bases and rates on sales for delivery into Louisiana within 60 days.
Maine	First day of the first month that begins at least thirty days after the seller has exceeded the threshold.
Maryland	First day of the month following when threshold is met

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When Do You Need to Register?

State	When You Need to Register Once You Exceed the Threshold
Massachusetts	First day of the first month that starts two months after the month in which the remote retailer first exceeded the $100,000 threshold, in the first year that it exceeds the threshold
Michigan	January 1 following the year the threshold is exceeded
Minnesota	First day of the calendar month occurring no later than 60 days after meeting or exceeding the threshold
Mississippi	Next transaction
Missouri	Not more than three months following the close of the preceding calendar quarter
Nebraska	The first day of the second calendar month after the threshold was exceeded
Nevada	By the first day of the calendar month that begins at least 30 calendar days after they hit the threshold
New Jersey	Required to collect on first taxable sale, 30 day grace period to register
New Mexico	January 1 following the year the threshold is exceeded
New York	Register within 30 days after meeting the threshold and begin to collect tax 20 days thereafter
North Carolina	Next transaction* Update based on the 2021 SST Disclosed Practice 8 submitted by the state; this has changed from 60 days to next transaction
North Dakota	The following calendar year or 60 days after the threshold is met, whichever is earlier
Ohio	Next day after meeting the threshold
Oklahoma	The first calendar month following the month when the threshold is met

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When Do You Need to Register?

State	When You Need to Register Once You Exceed the Threshold
Pennsylvania	April 1 following the calendar year when threshold was exceeded
Rhode Island	January 1 following the year the threshold is exceeded
South Carolina	The first day of the second calendar month after economic nexus is established
South Dakota	Next transaction
Tennessee	The first day of the third month following the month in which the dealer met the threshold, but no earlier than July 1, 2017
Texas	The first day of the fourth month after the month in which the seller exceeded the safe harbor threshold
Utah	Next transaction (state doesn't specify)
Vermont	First of the month after 30 days from the end of the quarter that you exceed the threshold
Virginia	Next transaction (state doesn't specify)
Washington	The first day of the month that starts at least 30 days after you meet the threshold
West Virginia	Next transaction (state doesn't specify)
Wisconsin	Next transaction
Wyoming	Next transaction

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Sales and Use Tax: The Nightmare Scenario

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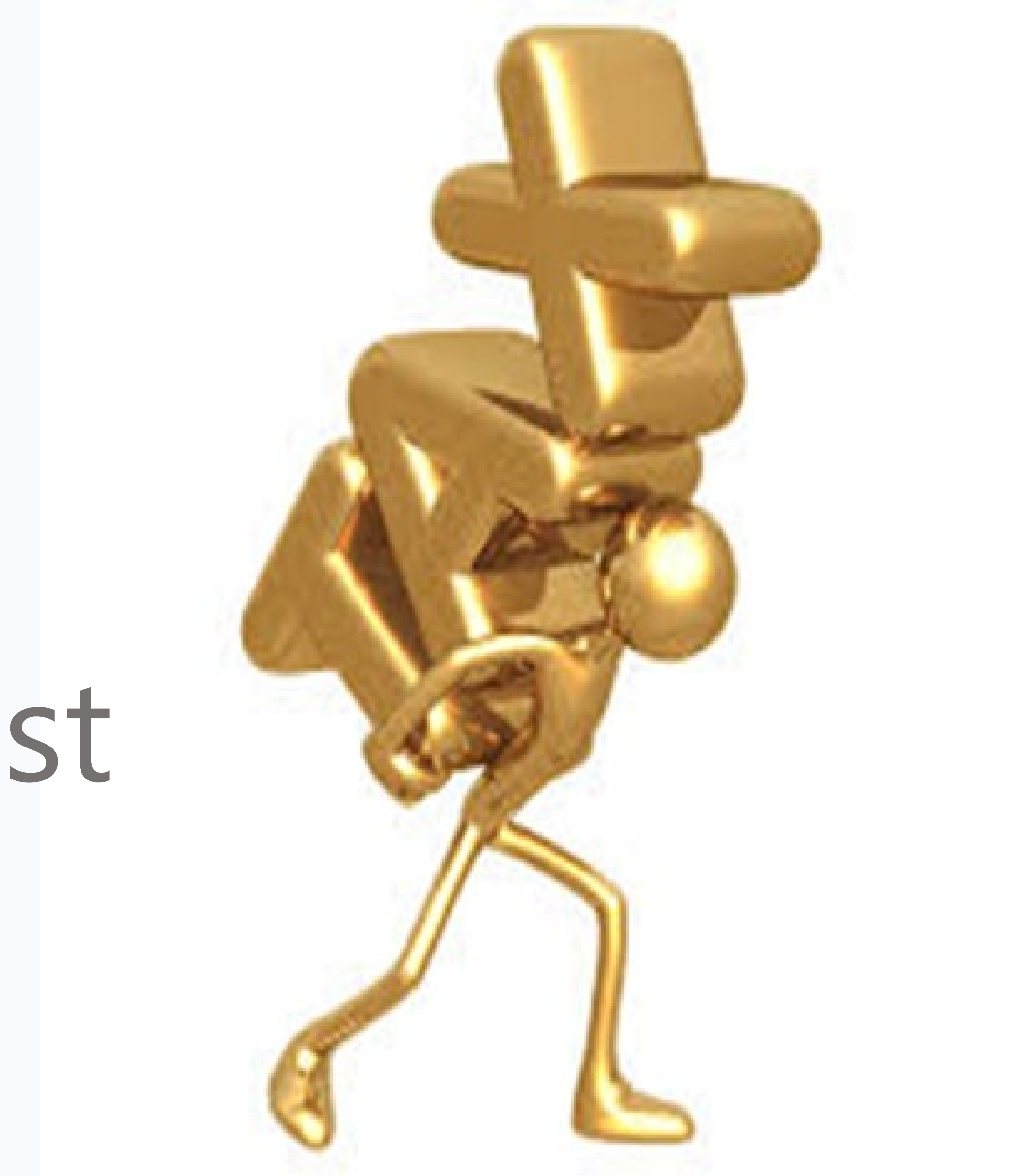
Sales and Use Tax Characteristics:

The Meanest Tax?

- Ubiquity
- Onerous Record Keeping
- Aggressive Audit Methodologies
- Pyramiding of Tax Liabilities
- Burdensome Penalties and Interest
- Personal Liability
- Advanced Audit Targeting
- Confusion!



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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- This is the story of a business that did everything correctly, yet still found itself fighting with the NYS Tax Department for more than eight years!

- 74 Wythe Restaurant Co. – operated a music performance venue that featured electronic dance music ("EDM") DJs and sold beverages.

Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- Some important dates:
  - April 2016 – initial audit commenced
  - August 2019 – initial audit assessment ($547K in tax)
  - August 2019 – BCMS protest filed for initial audit period
  - October 2019 – follow-up audit commences
  - September 2020 – follow-up audit assessment ($822K in tax)
  - May 2021 – DTA Petitions for follow-up audit assessment (mailing issue)
  - October 2021 – BCMS mediation on initial audit assessment
  - December 2022 – BCMS Order for initial audit assessment (taxpayer loses)
  - February 2023 – DTA Petition protesting BCMS Order
  - October 2023 – DTA ALJ Hearing
  - June 2024 – ALJ Decision
  - July 2024 – Tax Department Appeal???

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- So what's the issue/confusion?
- Wythe sold two things: (i) tickets to EDM DJ shows and (ii) drinks.
- For the first year of operation, Wythe taxed all its sales (tickets and drinks).
- Then its accounting professional came to them and said that they should not be taxing the ticket sales because admission charges to "live musical arts performances" were exempt from the tax imposed on admission charges to a place of amusement.

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- This change in filing pattern (100% taxable sales to 40% taxable sales) likely caused the audit. Remember, the Tax Department is watching!!
- After consultation with FAM, the auditors concluded that the tickets were taxable because EDM DJ sets do not qualify as live musical arts performances. According to the auditors, that exemption is only available to Broadway shows, not concerts. So the auditors hold the ticket sales as taxable admission charges to a place of amusement under Tax Law § 1105(f). Note that the auditors never attended any shows or visited the taxpayer.
- So who's right?

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

Taxpayer Support:

- 20 NYCRR 527.10
- TB-ST-8
- TSB-A-96(28)S

Auditor's "Support":

- TB-ST-535/Tax Law § 1115(x)???

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- On to the first level of appeals! We got involved at the BCMS stage and took the case to mediation.
- We presented a 30-page position letter detailing the musical events and the supporting authority.
- The case sits with the conferee for 14 months despite numerous emails and calls! And a new conferee is then assigned to the case.
- The audit team never responds to our position letter. Instead, the new conferee calls and says that the auditors now think the ticket sales are taxable under Tax Law § 1105(d), though they provide no analysis or written explanation of this position.

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- So what does 1105(d) tax?

- It taxes: "The receipts from every sale, other than sales for resale, of beer, wine or other alcoholic beverages or any other drink of any nature, or from every sale, other than sales for resale, of food and drink of any nature or of food alone, when sold in or by restaurants, taverns or other establishments in this state, or by caterers, <u>including in the amount of such receipts any cover, minimum, entertainment or other charge</u> made to patrons or customers…."

- Really?? Remember, Wythe charged tax on all its drink sales.

- Despite not having any written position from the auditors, the conferee sustained the assessment.

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- On to the next level of appeal! We protested the BCMS Order to the Division of Tax Appeals. In our petition, we allege that the Department is taxing the ticket sales pursuant to Tax Law §§ 1105(f) and 1105(d).

- In its answer, the Department refused to admit or deny the sections of the law that it was relying on to tax the ticket sales? Really??!!

- We have to file a Motion for a Bill of Particulars to get the Department to clarify its legal position, which they oppose, but which the ALJ grants.

- We then proceed to hearing.

Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- But first, there is a separate argument that pertains to the assessments in the follow-up audit. Neither Wythe nor any of the three individuals assessed as responsible persons for Wythe received the Notices of Determination.
- After reaching out to the Tax Department to confirm that the Notices were issued and submitting FOIL requests for the second audit file and assessments, we protested the Notices to BCMS.
- BCMS refused to hear the matter because the protests were not filed within 90 days of the issuance of the Notices. BCMS issued Orders dismissing the protests.
- We protested the dismissal to the Division of Tax Appeals.

Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- At hearing we present a mountain of evidence regarding:

  - The operation of the business.
  - The DJ performances (including audio/visual examples).
  - An expert witness to testify regarding the definition of music.
  - Documentation pertaining to the mailing errors for the assessments in the follow-up audits.

- At the hearing the Department presents the auditor, who:

  - Could not explain why the DJ performances weren't musical arts performances.
  - Admitted to never having seen any of the performances.
  - Could not define the applicable terms: "live," "music," and "performance."
  - Admitted that she did not issue the assessment based on Tax Law § 1105(d), and did not even know what that section of law covered.

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- After submitting briefs, the ALJ agrees with our position and cancels all the assessments!
- https://www.dta.ny.gov/pdf/determinations/830440.det.pdf.
- Big taxpayer win!!! But is it……?
- Is it over? The Department has until July 6 to appeal. And what about costs?

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Sales and Use Tax: The Nightmare Scenario

The Meanest Tax?

- Takeaways:

1. The Tax Department is watching changes in filing pattern.
2. The Tax Department may not come to the correct conclusions:
   i. The Tax Department ignored its own authority on the topic.
   ii. The Tax Department applied clearly inapplicable authority to the issue.
   iii. FAM provided incorrect advice on the legal issue.
3. The Tax Department changed its "theory of taxation" at the last minute, and then it refused to explain (or even acknowledge) that theory.
4. The Tax Department could not prove proper mailing of the Notices for the second audit.
5. Be sure to inform your client of how long the appeal process could take.

Sales Tax Hot Topic: Taxation of Digital Products & Software as a Service (SaaS)

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NYS Taxation of Digital Products

- What digital products are subject to tax in NYS?
  - Canned Software – whether physically or electronically transferred of accessed (e.g., electronic download, SaaS, etc.). Tax Law § 1105(a) – really?
  - Canned Information Services – any information that comes from a common database (i.e., is not personal or individual to the purchaser and can be sold to other purchasers). Tax Law § 1105(c)(1), see also TSB-M-10(7)S.
  - IT Security Services – can be taxable as either remote use of software (firewalls, anti-spamware, anti-malware, etc.) or as a protective service. N.Y. Tax Law § 1105(c)(8); TSB-A-20(49)S; TSB-A-16(20)S; TSB-A-10(14)S.

What digital products are NOT subject to tax in NYS?

- eBooks, Digital Movies/Songs – provided they do not contain functionality that could allow them to be characterized as software or qualify as an information service. TSB-M-11(5)S; TSB-A-11(20)S.

- Infrastructure as a Service – remote access of hardware (servers, CPUs, etc.) is not taxable. See TSB-A-15(2)S; TSB-A-17(21)S.

- Data Hosting Services – generally not taxable, but be careful. Can it be taxable as access to software? TSB-A-16(19)S.

- Software Maintenance – See Tax Law § 1115(o). But be careful: TSB-A-07(28)S.

The Primary Function Test

- But what if an otherwise nontaxable service has potentially taxable components?
- Enter the Primary Function Test.
- "…we cannot accept the Division's argument that the means by which a service is provided is the controlling factor in determining whether the subject service is taxable. To neglect the primary function of petitioners' business in order to dissect the service it provides into what appear to be taxable events stretches the application of Article 28 far beyond that contemplated by the Legislature." Matter of SSOV '81 Ltd. d/b/a People Resources, et al, DTA Nos. 810966, 810967, (TAT, Jan. 19, 1995).

Matter of Yesware, Inc.

- In the Matter of Yesware, Inc., Division of Tax Appeals, DTA Nos. 829638, 829639, and 829640, September 29, 2022:
  - The ALJ held Yesware was selling an exempt information service and not licensing taxable software.
  - Yesware's service was storage of client data and provision of access to it through Yesware's website and browser extensions. The company tracks, processes, and analyzes data it receives from recipients of its clients' emails and generates individualized reports to assist clients with their email prospecting and customer engagement efforts.
  - Critically, the license agreement was for the license to use the service, and not a license of software.
  - The ALJ applied the "primary function" test to determine that Yesware's bundled product was more service than software. What Yesware's clients really wanted were the reports Yesware generated.
  - https://www.dta.ny.gov/pdf/determinations/829638.det.pdf

Matter of Beeline.com, Inc., (May 2, 2024)

- The question was whether an on-line service provided by Petitioner that matched prospective employers looking for temporary employees with suppliers who provide contingent (temporary) employees was a taxable sale of software or a nontaxable provision of an unenumerated service.
- The taxpayer’s website highlighted how important the software was to the final product. According to the ALJ, “it is the software that streamlines, automates and integrates the entire bundle of services petitioner is selling.”
- “…the ultimate goal was to provide customers a seamless, automated and efficient system of fulfilling and monitoring their temporary employment needs, and that required, as the contract reflects, utilization of the software technology license.”
- The Tribunal agreed with the ALJ, finding the “technology was the central element of those contracts” and “customers were purchasing pre-written software that they used to facilitate the sourcing, hiring and management of contract labor.”
- The Tribunal rejected the Petitioner’s “primary function” analyses, ruling that these tests were not applicable to determine the taxability of a bundled sale in which one part of the bundle was services and the other part of the bundle was the sale of tangible personal property.

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Matter of Facilitysource, LLC (May 9, 2024)

- Petitioner sold facility management services to chain stores that included "24/7 call-in transaction center access, web-based portal access, work order management, vendor management, electronic invoicing, and data analytics."
- Petitioner licensed its "fmPilot" software to its customers, which facilitated these real property maintenance services.
- The ALJ (like the Tribunal in Beeline) found that the primary function test did not apply when services were bundled with tangible personal property (here, the software).
- Bad couple of weeks for the applicability of the primary function test to SaaS issues.

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Primary Function Takeaways

- Define the product appropriately – be specific and technical.
  - Emphasize the aspects of the service/product that are not automated or that require employee interaction. Too often these are left out of or not adequately described in contracts and invoicing.
  - Avoid problematic buzzwords like software, technology, platform, SaaS, licenses, etc.
  - Focus on nontaxable services where appropriate: data processing, logistics management, computing power, data storage, advertising services.
  - This is about who "uses" the software; the service provider or the customer?
  - Is the software integral or incidental to the service?
  - But ultimately, the facts of the situation will govern. If it quacks like a duck…..

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Audit Targeting and Best Practices

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Audit Targeting and Best Practices

- How does a business get chosen for audit?
- Audits of other taxpayers
- Whistleblower issues
- NY's CISS program
  - Corporate tax return sales v. sales tax return sales
  - Consistent taxable percentage
  - Drastic changes in filing pattern
  - New "self-audit" letters based on ratios and "typical" use tax liabilities.
  - Information from more sources (franchisers, insurance companies, liquor distributors, and financial institutions).
  - Compare returns of similar businesses operating within the same geographic areas
  - Lottery traffic vs. low sales.
  - Cash/credit card ratio out of sync with similar businesses.
  - Speeding and parking tickets.
  - The pre-audit analysis (auditors have info before taxpayer knows an audit is underway)

Audit Targeting and Best Practices

Department of Taxation and Finance

Transaction Field Audit Bureau - Buffalo District Office
77 Broadway, Suite 300, Buffalo, NY 14203-1642

Initial Here

March 17, 2023

[redacted]

Taxpayer ID: [redacted]
Audit Period: 12/01/2016 - 11/30/2022
Tax Article(s): 28 & 29
Case ID(s): [redacted]

We've scheduled an audit of your New York State Sales and Use Tax records.

A Tax Department auditor, **Mrs. Lisa Massey**, will be at your place of business on **May 2, 2023** at **9:00 AM** to begin the audit.

Please call your auditor, **Mrs. Lisa Massey**, at **(716) 855-5335** to confirm this initial conference.

Please confirm receipt of this Information Document Request (IDR) by either contacting your auditor by phone at the number listed above or returning an initialed copy of this letter. If not using U.S. Mail, see Publication 55, Designated Private Delivery Services.

What to expect
In a sales and use tax audit, Tax Department auditors will review your books and records to confirm that you've complied with all applicable tax laws. At the initial conference, the auditor can answer any questions you may have about the audit process.

To learn more, see the enclosed Publication 130F, *The New York State Tax Audit—Your Rights and Responsibilities* and Publication 900, *Important Information for Business Owners.*

Who should attend
Any of your business's officers or employees who are familiar with your business operations should attend the initial conference. If you've authorized someone to appear on your behalf during the audit, make sure that they bring a completed Power of Attorney (Form POA-1, available on our website, www.tax.ny.gov) to the meeting.

What books and records you must provide
You must show any and all documentation in auditable form and electronic form (if available) which supports the returns as filed. The enclosed IDR describes the books and records that you must have available at the initial conference. Please record the date each item is provided to the auditor in the "Date(s) Provided" column. Please also note what items are unavailable.

If records are voluminous, please discuss the IDR with the auditor. Audit techniques, as described in Pub 130F, can also be discussed at that time. The auditor may ask you to provide only a few items at the initial conference, or they may ask for specific records and information ***in addition*** to the items on the IDR.

Be sure to have ***all exemption certificates*** available at the initial conference. The auditor may ***disallow*** any certificates that:

- you do not provide; or
- are not properly completed.

Other taxes
This audit will focus on ***sales and use tax***. In the course of the audit, we may learn of issues regarding other kinds of taxes, such as personal income tax or corporation tax. If so, the Tax Department may expand the scope of the audit and conduct a multi-tax audit or a separate tax audit. If so, you must provide the auditors with records pertaining to these other taxes.

Communication by secure e-mail
The Tax Department's secure e-mail program allows taxpayers and their representatives to communicate electronically with auditors and to transfer data files quickly and securely. Please let your auditor know if you're interested in registering for the program.

Lisa Massey

Auditor name: Mrs. Lisa Massey
Auditor title: Field Audit Specialist
Auditor email: lisa.massey@tax.ny.gov

Supervisor name: Mr. Joseph N. Edwards
Supervisor phone: (716) 855-5335
Supervisor email: joseph.edwards@tax.ny.gov

Enclosures: Assistance Information Flasher
Information Document Request #01
Publication 130F
Publication 900
Sales Tax Questionnaire
Responsible Person Questionnaire
Computer Audit Feasibility Questionnaire

Audit Targeting and Best Practices

NEW YORK STATE | Department of Taxation and Finance

Transaction Field Audit Bureau - Long Island Regional Office
NYS Office Building, 250 Veterans Memorial Highway, Hauppauge, NY 11788-5599

March 22, 2023

Audit case ID: [redacted]
Tax type: Sales and Use Tax
Tax articles: 28 & 29
Audit period: 03/01/2020-02/28/2023
Taxpayer ID: [redacted]

[redacted]

We selected your New York State sales and use tax records for an audit.

This letter is to inform you that we will examine your records. Review the attached Information Document Request (IDR).

What to expect

A Tax Department auditor, Mrs. Kenichia Osbourne, will review your books and records to confirm you complied with all applicable tax laws. The auditor can answer any questions you may have about the audit process at any time.

To learn more, see the enclosed Publication 130-F, *The New York State Tax Audit—Your Rights and Responsibilities*, and Publication 900, *Important Information for Business Owners.*

What books and records you must provide

You must provide all documentation in auditable form and electronic form (if available) to support the returns as filed. The enclosed IDR describes the books and records that you must provide.

If your records are voluminous, discuss the IDR with the auditor. You can also discuss audit techniques, as described in Publication 130-F, at that time.

As the audit progresses, the auditor may ask you to provide records and information **in addition** to the items on the IDR. **We may schedule a field visit to review the information requested.**

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Other taxes

During the audit, we may learn of issues regarding other kinds of taxes. If so, we may expand the scope of the audit and conduct a multi-tax audit or a separate tax audit and you must provide the auditors with records pertaining to these other taxes.

Secure communication and data transfer

The Tax Department's secure e-mail program allows taxpayers and their representatives to communicate electronically with auditors and to transfer data files quickly and securely.

We also offer a secure data transfer tool for taxpayers and their representatives to share electronic files with their auditor.

Let your auditor know if you are interested in using either program.

Questionnaires

We enclosed one or more questionnaires requesting information about your business. The information that you provide on the questionnaires will help the audit process.

Please fill them out and return them by 04/05/2023:

- by mail to the address above;
- by secure email; or
- by FAX at (518) 435-8564.

What to do next

1. Call your auditor by **04/05/2023**, at the number below to confirm receipt of the IDR.
2. Compile all items on the IDR and send them to your auditor by the date shown on the IDR.

Questions?

- Visit our website
- Contact your auditor at the phone number below

Auditor name: **Mrs. Kenichia Osbourne**
Auditor phone: **(631) 595-4323**
Auditor email: **Kenichia.osbourne@tax.ny.gov**

Supervisor name: **Mrs. Mary Ohara**
Supervisor phone: **(631) 595-4242**
Supervisor email: **Mary.Ohara@tax.ny.gov**

Enclosures: Assistance Information Flasher
Information Document Request #01
Publication 130F
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Responsible Person Questionnaire
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Audit Targeting and Best Practices

New York State Department of Taxation and Finance
www.tax.ny.gov
Transaction Field Audit Bureau
Long Island Regional Office
NYS Office Building, 250 Veterans Memorial Highway, Hauppauge, NY 11788-5599
Phone: (631) 595-4203 Fax: (518) 435-8564

IDR #01

Information Document Request

Taxpayer name: [redacted]	Audit years: 03/01/2020 - 02/28/2023
Identification number: [redacted]	Case ID: [redacted]
Auditor: Mrs. Kenichia Osbourne	Article(s): 28 & 29
Requested of: [redacted]	Date requested: March 22, 2023

Date(s) Provided column completed by:

Your response is due by: 04/05/2023

Name

Description of documents and information requested:	*Date(s) Provided*
1. Sales tax returns, worksheets, and canceled checks showing taxes paid	
2. Federal income tax returns (Forms 1120, 1065, or 1040)	
3. New York State corporation tax returns	
4. General ledger	
5. Year-end trial balance	
6. Year-end financial statements	
7. General journal and closing entries	
8. Sales invoices	
9. All exemption documents supporting non-taxable sales, including: • resale, exempt use, exempt organization, and capital improvement certificates • any other documentation necessary to prove non-taxable sales	
10. Chart of accounts	
11. Fixed asset purchase/sales invoices	
12. Expense purchase invoices	
13. Merchandise purchase invoices	

Taxpayers are required to make all books and records available to the auditor, and they must remain available until the audit is complete, unless the auditor indicates that the records are no longer needed. An entry in the right column does not necessarily indicate that this portion of the request has been fully satisfied.

[redacted] Audit Period 03/01/2020 - 02/28/2023 [redacted]

14. Bank statements, canceled checks, and deposit slips for all accounts	
15. Cash receipts journal -- including sales journal, if applicable	
16. Cash disbursement journal -- including purchase journal, if applicable	
17. The corporate book, including minutes, board of directors, and articles of Incorporation	
18. Depreciation schedules	
19. Lease/Rental Agreements	

Audit Targeting and Best Practices

New York State Department of Taxation and Finance

Sales Tax Examination Questionnaire

DO-1632 (8/14)

Name of business		
Address (number and street)		
City	State	Zip

If you have any of the following identification (ID) numbers, enter them in the spaces below

Sales tax ID number	State Liquor Authority ID number	NYS Lottery ID number
NYS DMV ID number	Corporation Tax ID number	

Print or type your answers to the following questions. Attach additional sheets if necessary.

1. Whom should we contact to start our examination?

Name	
Business address	
Title	Telephone number ( )

2. What types of products or services does your company sell or provide? ______

3. Did you acquire this business (or assets of a business) from a registered sales tax vendor? ...... Yes ☐ No ☐

   If *Yes*, have you filed Form AU-196.10, *Notification of Sale, Transfer, or Assignment in Bulk*, with the Tax Department? Yes ☐ No ☐

Former owner's name	Federal employer ID number (EIN)
Address	

4. Does your company have a Web site? ...... Yes ☐ No ☐

   If *Yes*, provide Web address: ______

5. Does your company make sales through this Web site? ...... Yes ☐ No ☐

6. Are sales made on the Internet through an affiliated company? Yes ☐ No ☐

   If *Yes*, complete the following:

Name of affiliated company	Web address	Federal EIN

7. Do you make tax-exempt sales? ...... Yes ☐ No ☐

   If Yes, what is the basis for exemption? *(mark an X in all that apply)*:

   Purchasers provide exemption certificates ☐ Sales delivered out-of-state ☐

   Sales are not taxable ☐ Explain ______

   Other ☐ Explain ______

8. Are there seasonal or other fluctuations in sales? ...... Yes ☐ No ☐

   If Yes, explain ______

New York State Department of Taxation and Finance

Responsible Person Questionnaire

AU-431 (1/10)

Complete a questionnaire for each responsible person of the business

Business name		
Sales tax identification number	Case number	Audit period

Identification section

Name of responsible person		Social security number
Title		Physical mailing address
Period served	Percent of time devoted to business	

For the person named above, mark an X in the appropriate box for each item below.

	Yes	No	Not applicable or unknown
1. Is he or she responsible for preparing or supervising the preparation of sales tax returns and ensuring the remittance of tax?	☐	☐	☐
2. Does he or she participate in making significant business decisions?	☐	☐	☐
3. Is he or she responsible for maintaining and managing the business?	☐	☐	☐
4. Does he or she own:			
• corporate stock?	☐	☐	☐
• voting stock?	☐	☐	☐
5. Does he or she derive substantial income or have a substantial economic stake in the business?	☐	☐	☐
6. Does he or she have authority to:			
• manage the business with knowledge and control over financial affairs?	☐	☐	☐
• pay or direct payment of bills or other business liabilities?	☐	☐	☐
• sign checks?	☐	☐	☐
• act on behalf of the business, with the Tax department?	☐	☐	☐
• sign consents extending periods of limitation?	☐	☐	☐
• sign power of attorney for the business?	☐	☐	☐
• sign consent fixing tax?	☐	☐	☐
• sign installment payment agreements?	☐	☐	☐
• hire and fire employees?	☐	☐	☐
• negotiate loans, borrow money for the business, or guarantee business loans	☐	☐	☐

7. Describe any additional responsibilities not listed above: ______

(Continued on back page)

Audit Targeting and Best Practices

- Auditors look at a few key areas:

1. Tax reconciliation.
2. Expenses - usually recurring - use of test period or statistic sample preferred.
3. Sales - usually sampled, depends on level of sales activity: guest checks - register tapes - taxable ratio.
4. Capital acquisitions - full detail usually preferred, items usually reconciled with cash disbursements journal and federal depreciation schedule.

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ATTORNEYS

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- Audit Methodology

1. Direct Audit
   - What qualifies as "adequate records"?
   - Typical for non-cash businesses
   - Test Period Consent

2. Indirect or Estimated Audit Methodologies
   - Records must be requested and deemed inadequate
   - Observation Test
   - Purchase Markup Test
   - Cash to Credit Card Test
   - Industry Indices Test (e.g., rent to sales ratio)
   - Beware income tax issues!

Audit Targeting and Best Practices

- Concluding An Audit
  1. Audit Work Papers
  2. Presumption of Correctness and Burden of Proof Issues
  3. Penalties:

     i. Failure to File (max 30% of tax due)
     ii. Substantial Understatement (10% of amount omitted)
     iii. Fraud (200% of tax due)
     iv. interest (14.5%)

  4. Closing Agreements
  5. Follow-Up Audits

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- Issues to review to mitigate audit liabilities:

  1. Customer paid use tax, direct pay permits, etc.?
  2. Customer or transaction exempt?
  3. Overlapping audit policy?
  4. Chargeback customer? Six year statute of limitations on contract claims. May not be the best business decision.

- Send the customers an XYZ letter inquiring about these issues.

Hodgson Russ LLP
ATTORNEYS

Questions?

Hodgson Russ LLP ATTORNEYS

HODGSON RUSS

Contact Us

Mark S. Klein

Partner

646. 218.7514

mklein@hodgsonruss.com

Open Weaver Banks

Partner

646.218.7524

obanks@hodgsonruss.com

JOSEPH N. ENDRES

Partner

716.848.1504

jendres@hodgsonruss.com

JOSEPH F. TANTILLO

Associate

716.848.1639

jtantill@hodgsonruss.com

Hodgson Russ LLP
ATTORNEYS