COMMON PITFALLS IN THE ADMINISTRATION OF PROPERTY AND SALES & USE TAXES

OCTOBER 25, 2017
AGENDA

Property Taxes
- What is property tax and why does it matter?
- Fair Market Value Concept
- Personal Property Pitfalls
- Real Property Pitfalls
- Audit Pitfalls
- State Updates

Sales & Use Taxes
- Significant Process and Control Risk Areas (& Survey Results)
- Common Areas Presenting Challenges & Best Practices
  - Nexus
    - Update on nexus developments & notice/reporting requirements
  - Taxability (Revenue Side)
  - Audits
  - Loss Contingencies

Q&A

CPE: Be sure to respond to attendance tracker when prompted to ensure CPE credit.
Common Pitfalls - Property Taxes
What is Property Tax?

Ad Valorem - “Adding to Value”

- A tax imposed by local government as primary source of income for local government services such as parks, fire protection, police, schools, public works and public health
- Based on the principle that the amount of tax paid should depend on the value of property owned as of the lien date (generally January 1)
Significance of Property Taxes

In fiscal year 2016, property taxes on real and personal property owned/leased by businesses accounted for the largest share of total state and local business taxes in the U.S.

$250.4 Billion!
Taxable Property

All fifty states allow local jurisdictions to tax the ownership of real property situated within the jurisdiction. Thirty-eight states tax personal property. Approximately 11 of the 38 states tax inventory.
Taxable Property

254 counties in Texas tax Personal and Real property

States that exempt personal property: Delaware, Hawaii, Illinois, Iowa, Minnesota, New Hampshire, New Jersey, New York, North Dakota, Ohio, South Dakota, Pennsylvania
**Fair Market Value Concept**

**Assessor’s Principle Duty** — Determine FMV of Property

**FMV** - What a willing buyer would pay to a willing seller in an open market

**States may define value differently**
- **MI:** True Value
- **IN:** True Tax Value
- **TX:** Appraised Market Value
- **FL:** Just Value

Assessors utilize 3 approaches to value:

- Cost Approach
- Market Approach
- Income Approach

**FMV**
Calculation of Property Tax

\[
\frac{\text{Cost of Government}}{\text{Total Equalized Value of Properties}} \times \text{Tax Rate} = \text{Your Taxes}
\]
Personal Property Pitfalls

- Maintaining an accurate compliance calendar
  - Return due dates
  - Tax bill payment dates
  - Location address
  - Account number

- Monitoring assessment notices
  - It is important to review assessor proposed assessment versus estimated assessment for useful life errors, cost input errors, and non-taxable items being included in the assessment
  - Monitoring is also important so the taxpayer knows their administrative remedies (appeals)

- Communication between management and tax department
  - Awareness of mergers & acquisitions and disposal of property
  - Avoiding ‘forced’ or ‘estimated’ assessments

- Physical situs and status of tangible personal property assets
  - Inability in fixed asset listings to distinguish idle equipment from active machinery
  - Assets coded to HQ versus physical location of the asset

- Capitalization Thresholds
  - Taxpayers internal capitalization threshold versus local reporting requirements
Real Property Pitfalls

- Review of property record cards from assessing officials for accuracy
  - Square footage discrepancy
  - Use of property discrepancy
    - Does the assessor have an accurate breakdown of the functions of the facility? (e.g. office SF, warehouse SF, production SF)
  - In many cases it has been years since an assessing official has toured a taxpayers facility
    - Highlighting any of the negative features of a subject property (obsolescence, maintenance reserves, etc.)
  - Cost to cure unique features undesirable to the highest and best use potential buyer

- Information requests from assessing officials
  - Statutory requirement to respond or data gathering purposes only

- Inability to property calculate market value of small scale changes to large facilities
  - Capital expenditures on the real property does not always equal an increase in market value
Audit Pitfalls

- Personal property audits
  - Requests are not typically tailored to an individual taxpayer
  - Can be facilitated by the local jurisdiction or by an outside party hired on behalf of a jurisdiction
- Framing auditors expectations
  - Document exchanges
  - Invoices for purchased property
  - Desk audit versus physical tour of a facility
  - Timing of responses
  - Audit period

- Audit trigger points
  - Large swings in reported assets
  - Ownership changes
  - Local audits are on the rise and jurisdictions search for more tax dollars

- Explain reporting variances
  - Was business winding down?
  - Was production diminished during the audit period?
Audit Pitfalls

- **Mitigate liability/refund opportunity**
  - Look for opportunities to remove assets that may not have been properly reported
    - Ghost asset studies
    - Physical inventory of tangible personal property
    - Assets assigned to a location but are not physically located at the site

- **Auditor’s Findings**
  - Taxpayer needs to know their rights of appeal should they disagree with the auditor’s findings

- **Contingent Fee Auditors**
  - How they’re paid
  - Incentives during audit
Florida: Legislature Exempts Solar Equipment from Property Tax

May 4, 2017, the legislature enrolled a bill for the governor's signature regarding renewable energy devices, such as solar panels, exempting 80% of their taxable value from county ad valorem taxation. Florida law already provides a 100% exemption for residential solar installations. This bill, however, addresses non-residential solar installations, such as commercial rooftop installations and utility-scale solar farms. Takes effect January 1, 2018.

Texas: Legislature Changes Due Dates and Appeal Deadline For 2018

• Rendition statements and property reports must be delivered to the chief appraiser not later than April 1 (changed from April 15).
• Freeport Exemption application due April 1 (change from April 30).
• Value protest deadline is May 15 (changed from May 31st).
State Updates

- Wisconsin - 2017-2019 Budget Enacted

Governor Scott Walker signed the fiscal 2017-2019 budget on 9/20/17, containing a cut to local property taxes on business machinery. This change does not impact existing manufacturers in the state that already receive the exemption on machinery & equipment that is used 95% of the time for production purposes. State Representative Nygren and State Senator Darling introduced Omnibus Motion 418 to address the states need to back fill the lost revenue of local jurisdictions. Motion 418 creates a state aid program that will be administered by the DOR to make payments to the local jurisdictions. Beginning in fiscal 2018-2019, the estimated state aid payments to local jurisdictions is set at $74,400,000. For taxpayers who file business personal property tax returns, guidance is expected to be released by the DOR prior to 12/31/17 for their 2018 business personal property tax filings.
State Updates

Michigan - Proposed Updates to the General Property Tax Act

Senate Bill 570 has been passed by the Senate and is expected to be passed by the House. The bill would amend the filing deadline for personal property filings to allow for the delivery via U.S. Postal Service to be considered timely filed if it were postmarked by the February 20 deadline and received by the local assessor at least one week before the March meeting of the board of review began. The revised terms would be applicable to the filing of annual personal property statements, the combined document of qualified new and qualified previously existing eligible manufacturing personal property ("EMPP"), and “small parcel exemption” filings. Additionally, the bill would allow a late application for the EMPP to be filed directly with the March board of review before it adjourned, if a combined document were not filed on time.
Common Pitfalls - Sales & Use Taxes
COMMON PITFALLS TIED TO PROCESS & CONTROLS

Critical Areas

- Nexus - Trigger for state tax obligations
- Compliance - Registration and filing where required
- Taxability Determinations - Sales and purchase transactions
- Tax Application (Process/systems that apply taxability decisions & rates to sales and purchase transactions)
- Compliance Process
- Exemption Documentation (collection, validation, maintenance)
- Audit Program

Informal survey conducted through our State and Local Tax portal
COMMON PITFALLS: SALES & USE TAX PROCESS & CONTROLS

SURVEY: Strong process and controls in your business? (YES%)

• (40%) Nexus - Trigger for state tax obligations
• (80%) Compliance - Registration and filing where required
• (70%) Taxability: Sales and purchase transactions
• Tax Application (Process/systems that apply taxability decisions & rates to sales and purchase transactions)
  • (55%) Sales
  • (75%) Purchases (self-assessment process)
• (70%) Compliance Process
• (60%) Exemption Documentation (collection, validation, maintenance)
• (50%) Audit Program
COMMON PITFALLS: NEXUS

What is it?

• Nexus - Trigger for state tax obligations
  • “Minimum Connection” (level of activity) before state can assert
• Established by a long line of U.S. Supreme Court cases (Commerce & Due Process Clauses)
• Controlling case today: Quill Corp. v. North Dakota, 504 US 298 (1992)
  • The Court held physical presence required for nexus (long standing rule)
  • In a recent concurring opinion, Justice Kennedy wrote:
    “Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of [Quill].” DMA v. Brohl.
• Movement by the states to “Kill Quill” (want tax on Internet revenue)
• Presently leading the way: South Dakota v. Wayfair, Inc.
  - Economic nexus case (no physical presence) ruled unconstitutional by the SD Supreme Court under precedent established in Quill (Just what the state wanted!)
  - Cert. Petition filed with the U.S. Supreme Court on 10/3/2017
COMMON PITFALLS: NEXUS

Categories

PHYSICAL PRESENCE
• Generally: permanent or temporary presence of property, employees, agents, sub-contractors
• Click-Through Nexus: A rebuttable presumption based upon paid referrals by in-state company (varying thresholds apply)
• Affiliate Nexus: Affiliate with in-state presence helps company make a market in the state.

ECONOMIC NEXUS (NEWER) (push to expand nexus, Kill Quill)
• Varying in-state annual sales and or number of transactions, often coupled with additional in-state activity or presence (but not always)

MARKETPLACE NEXUS (COMING SOON TO MINNESOTA & WASHINGTON)
## ECONOMIC NEXUS
### States with Active Provisions

<table>
<thead>
<tr>
<th>State</th>
<th>Authority</th>
<th>Effective Date</th>
<th>Annual Sales Threshold</th>
<th>No. of Annual In-State Transactions</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Reg/Policy</td>
<td>1/1/2016</td>
<td>$250k</td>
<td>N/A</td>
<td>Plus, in-state advertising</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Policy &amp; Legislation</td>
<td>3/1/2017</td>
<td>100</td>
<td></td>
<td>Plus, consider other substantial economic presence factors</td>
</tr>
<tr>
<td>Indiana</td>
<td>Legislation</td>
<td>7/1/2017</td>
<td>$100k or 200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mississippi</td>
<td>Reg/Policy</td>
<td>7/1/2017</td>
<td>$250k</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Wyoming</td>
<td>Legislation</td>
<td>7/1/2017</td>
<td>$100k</td>
<td>or 200</td>
<td></td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Legislation</td>
<td>8/1/2017</td>
<td>$100k or 200</td>
<td></td>
<td>Plus, software/cookies or in-state retail facilitator or referrer</td>
</tr>
<tr>
<td>Maine</td>
<td>Legislation</td>
<td>10/1/2017</td>
<td>$100k</td>
<td>or 200</td>
<td></td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Reg/Policy</td>
<td>10/1/2017</td>
<td>$500k and 100</td>
<td></td>
<td>Plus, additional contacts (e.g., software, apps, cookies)</td>
</tr>
<tr>
<td>Ohio</td>
<td>Legislation</td>
<td>1/1/18</td>
<td>$500k</td>
<td></td>
<td>Plus, uses in-state software or content distribution network</td>
</tr>
</tbody>
</table>
Economic Nexus – Sales & Use Taxes

- Legislation introduced (2017)
- Active
- Effective 1/1/2018
- On hold/challenged or pending Quill
SALES AND USE TAX NEXUS DECISION TREE

DOES YOUR BUSINESS HAVE THE FOLLOWING?

START

Facilities, employees, inventory or other property permanently located in the state

NO

Employees or property temporarily located in the state (installation, services, delivery trucks)

NO

Agents permanently or temporarily in the state (independent sales representatives, service providers, subcontractors)

NO

In-state referral agent (paid fees or commissions) that assists with establishing the market in-state

NO

In-state, related entity that assists your business with establishing a market in the state (solicitation, services, similar name or brand)

NO

In-state presence consisting of annual sales revenue or sales transaction volume exceeding state’s threshold

NO

YES

YES

YES

YES

NO

NO

NO

NO

NO

NO

NO

NEXUS

Physical Presence

Click-Through

Affiliate

Economic

Nexus Conclusion Generally

Traditional Physical Presence Nexus Established

Click-Through Nexus Presumption Established

Affiliate Nexus Established

Economic Nexus Established

NO NEXUS

Footnotes:

1. All states have traditional physical presence nexus (Quill Corp. v. North Dakota, 504 US 298 (1992)).
2. Approximately 20 states have click-through nexus provisions that establish a nexus presumption if click-through sales exceed the state’s threshold (commonly, $100,000 of sales from annual referrals). Another dozen or so states indicate that existing general nexus provisions already include click-through nexus activities.
3. Approximately 13 states have affiliate nexus provisions where an in-state, related entity can establish nexus for the out-of-state affiliate retailer (e.g., accept customer returns, sell under same name or brand).
4. Several states have adopted or proposed economic nexus statutes or regulations establishing nexus for out-of-state retailers meeting certain economic conditions (common annual sales of $100,000 or 200 sales transactions annually (when accompanied by certain marketing activities). The legality of such provisions is being challenged in some states due to apparent conflict with the Quill standard.

IMPORTANT: Sales tax nexus is a complex and quickly evolving area. The above chart provides an overview of the general decision making involved in making nexus determinations and should not be used in place of a detailed nexus study to determine state-specific tax obligations. There are many variations of the above nexus provisions among the states that must be considered and there may be additional considerations not represented in the above chart.
COMMON PITFALLS: NO NEXUS?
Remote Sellers May Have Notice & Reporting Obligations

- Colorado law (enacted in 2010) requires an out-of-state retailer (without nexus) with gross annual sales exceeding $100,000 to:
  - Send notice to Colorado customers that their purchases may be subject to use tax;
  - Send customers an annual summary if aggregate purchases exceed $500;
  - Enforcement began 7/1/2017, after U.S. Court of Appeals (10th cir) found the notice/reporting law did not violate commerce clause (Quill did not apply outside sales tax collection). Direct Marketing Association v. Brohl.

- Following DMA decision, states with similar provisions announced enforcement of the laws and other states began introducing legislation.
## NOTICE & REPORTING
### States with Active Provisions

<table>
<thead>
<tr>
<th>State</th>
<th>Effective Date</th>
<th>Minimum State Sales</th>
<th>Notice to Customers (website, other docs)</th>
<th>Annual Report to Customers</th>
<th>Annual Report to State</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oklahoma</td>
<td>11/1/2016</td>
<td>None Specified</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Colorado</td>
<td>7/1/2017</td>
<td>$100k</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Kentucky</td>
<td>7/1/2017</td>
<td>$100k</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Louisiana</td>
<td>7/1/2017</td>
<td>$50k</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Rhode Island</td>
<td>8/17/2017</td>
<td>None Specified</td>
<td>Yes (if &gt;=$100)</td>
<td>Yes (Attestation)</td>
<td></td>
<td>Alternative to complying with economic nexus</td>
</tr>
<tr>
<td>South Dakota</td>
<td>7/1/2011</td>
<td>$100k</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Vermont</td>
<td>7/1/2017</td>
<td>Yes (if &gt;=$500)</td>
<td>Yes (if &gt;=$100k)</td>
<td>Yes (if &gt;=$100k)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Washington</td>
<td>1/1/18</td>
<td>$10k</td>
<td>Yes</td>
<td></td>
<td></td>
<td>Alternatively, may register and collect</td>
</tr>
</tbody>
</table>

Note: Alabama and Nevada also have laws authorizing notice requirements.
BEST PRACTICES: NEXUS
Monitor/Track Activities & Nexus Law Developments

- Develop process for monitoring/tracking nexus activities:
  - Real Time, Quarterly, Annually as appropriate for the business.

- Physical presence (not exhaustive)
  - Track employee locations and travel, including duration
  - Evaluate agency, sub-contractor relationships for service performed
  - Track property movements, including inventory, trucks, computers

- Click-through nexus:
  - Evaluate marketing relationships and contract terms in real time
  - Build in safe harbors to rebut nexus presumption
BEST PRACTICES: NEXUS
Monitor/Track Activities & Nexus Law Developments

• Affiliate nexus:
  - Watch for services provided by affiliates in the state (e.g., accepting returns)
  - Promoting similar products or brands may be problematic for remote affiliate

• Economic Nexus
  - States have been less aggressive on pure economic nexus provisions, but risk remains and must be evaluated
  - Some states have layered in-state presence activities into economic nexus provisions; strengthens state’s position
  - Monitor developments of South Dakota Wayfair petition at Supreme Court level
  - Monitor annual sales and transaction volumes for exceeding state economic nexus thresholds
BEST PRACTICES: TAXABILITY & TAX APPLICATION

Determine Taxability of Products and Services (Sales)

- Document product/service descriptions for taxability analysis

- Update taxability of products/services on periodic basis (consider more frequent updates for evolving areas, e.g., technology, services)

- If using a sales tax engine (software), critical to ensure proper mapping to the tax engine’s categories (based upon product/service descriptions)

- Tax rates should be updated on a monthly basis (rate service recommended for home grown systems)
BEST PRACTICES: EXEMPTION DOCUMENTATION
Collection, Validation, Maintenance

• If nexus exists, collection of exemption documentation is required to document exempt sales
  - Consider collecting even if no nexus (one process for all exempt sales)

• Validation critical: proper form, fully completed/signed, applies to specific purchase (third party services available for high volume), blanket/single
  - Determine approach: whether to strictly collect tax if no certificate or follow up (may lead to refund claims)
  - Special rules for drop shipments, multistate use

• Maintenance:
  - Ensure retrieval over several years; proper indexing; electronic storage recommended
  - Track expiration dates; update other blanket forms every 3-5 years
BEST PRACTICES: AUDITS
Implement Audit Program

“By failing to prepare, you are preparing to fail.” Benjamin Franklin

- Control the audit by ensuring availability and design of reports to be utilized for audit (know what you are going to provide before the state asks)
- Ensure reconciliation to key control documents in advance of audit, e.g., income tax returns, financial statements
- Review prior audit and implementation of corrective measures
- Identify system change dates, acquisitions, other transactions to isolate
  - Use information to request test periods, identify exceptions
- Pre-audit sample data to anticipate audit issues
- Opening conference: ensure agreed upon approach to audit, timing and document
- Maintain reasonable level of flexibility with auditor and good relationship
“Manage the audit. Don’t let it manage you.”

- Maintain audit control log and supporting files to document the audit
  - Correspondence received and issued
  - Information requests and prompt responses
  - Meetings and documented agreements/settled issues (avoid re-visiting)
  - Actionable notices, timelines and actions taken

- Establish policy for waivers
  - Hold auditor accountable to agreed-upon timelines
  - Consider reasonable requests, understand ramifications for refusal
  - Push back may be warranted if sufficient time to audit is not allowed
  - Documentation critical (use correspondence control log)

- Protests & Appeals - follow procedures and timelines strictly
QUESTIONS?

Thank you for attending!