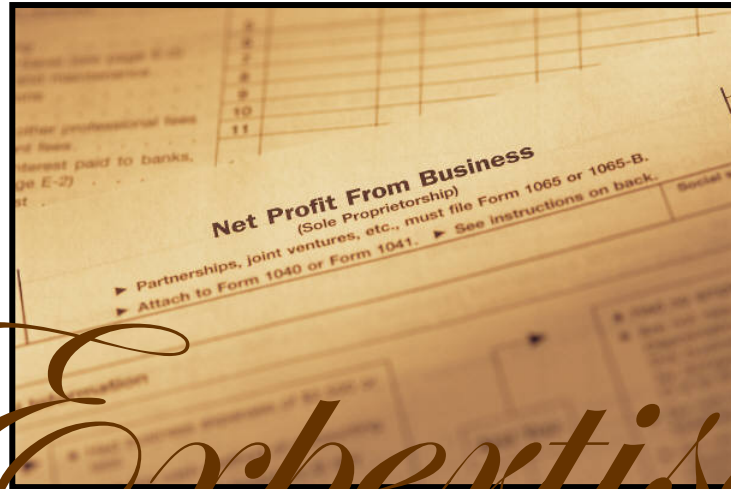


# STATE AND LOCAL TAXES



*Expertise*



## Daszkal Bolton LLP

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# Introduction to state and local taxes

State and Local Taxes (SALT) can often equal or exceed a company's federal tax liability. The lack of uniformity in state tax laws serves to complicate matters by increasing the complexity of managing business operations in multiple locations.

In an economic climate where most states are experiencing a revenue crunch, state governments are looking for new ways to raise money. State and local tax compliance, particularly in the areas of income, franchise, sales and use taxation (including internet commerce), is being enforced with renewed vigor. Uncollected sales tax on e-commerce is currently estimated at \$20 billion per year, with projections up to \$50 billion within the next five years unless streamlined federal legislation is implemented. The state of Florida, along with many other states, has expanded its audit campaign in an attempt to capture this revenue. This aggressive crusade may put your company in financial jeopardy if you are not compliant with existing laws.

Daszkal Bolton distinguishes itself from other firms our size by dedicating resources exclusively to state and local tax matters. Our SALT team provides consultative services, as well as assistance in managing the state and local tax consequences of operating and/or expansion into multiple jurisdictions. Our in-house SALT experts specialize exclusively in state and local taxation with a primary focus on income/franchise, sales/use and transactional taxes. Our SALT team also provides audit defense services for individuals and corporations. We assist our clients on a multi-state level, with immediate access to national resources through our affiliation with AGN International and other strategic alliances.

Whether you are an individual, own a start-up business or have an established company, we help ensure that you are in compliance with the myriad of state tax laws. We work with you to maximize your profit and available tax credits while minimizing your state and local tax burden.

Our state and local tax team provides expertise in the following areas:

- Restructuring business operations to minimize state and local taxes, including implementation of recommended tax advice and strategic tax planning
- Representing corporations in state tax audits, settlement negotiations, ruling requests and refund procedures
- Performing reverse audits to identify missed opportunities and refund potential
- Representing individuals with personal income tax audits on change of residency to Florida from states with a personal income tax (such as New York, New Jersey and California)
- Reviewing multi-state tax consequences of mergers, acquisitions and dispositions with multi-state interests
- Income/franchise and sales/use tax compliance reviews based upon existing or proposed operations from a multi-state standpoint
- Providing expert witness testimony to resolve complex tax controversies
- Identifying state tax refund opportunities and/or tax exposures, recommending and implementing cost-effective solutions
- Reviewing transactional taxes on financing and banking transactions, providing alternative solutions to minimize or avoid such taxes
- Determining which credits or incentives could help you improve your cash flow

# Are you a target for a Florida sales tax audit?

Do you sell goods at retail or wholesale?

Do you manufacture a product for sale?

Do you sell a taxable service in Florida?

Do you purchase supplies for your business from out of state vendors or via the internet?

If any of the above applies, your business could be a target for a sales and use tax audit. As the need for state revenue continues to grow, Florida's audit activity continues to grow. Our sources tell us that the companies at greatest risk for sales tax audits are manufacturers, retailers and service providers. Because state tax audits significantly outnumber Internal Revenue Service (IRS) audits, make sure that you are in compliance or be fully prepared before you are audited.

## Manufacturers

Manufacturers are prime targets for sales and use tax audits. Many manufacturers are under the false impression that they are afforded generous sales tax exemptions and therefore do not need to worry about sales tax. The truth is that manufacturers face a myriad of complex sales tax rules which can often make even the most seasoned tax expert grimace. While Florida offers certain tax incentives to manufacturers, it also imposes sales tax on most of the materials purchased for a manufacturer's business. In certain cases, the state also imposes a sales tax on the cost of labor necessary to make a product - you are expected to self-assess a tax on your fabrication costs. That adds up to an additional 6% of overhead for your business (more if you are subject to the sales surtax). We have been advised by sources within the Florida Department of Revenue that when audited, many manufacturers have been required to pay sales tax on up to 100% of it labor costs.

## Retailers and Service Providers

Rapidly growing retailers are likely targets for a sales tax audit, but any retailer could be targeted. Retailers often fail to properly address sales tax on out-of-state sales and/or exempt sales and therefore put themselves at risk for an audit. In our experience, retailers also fail to properly calculate Florida's sales surtax. These errors could cost you significant tax dollars.

Florida imposes sales taxes on purchases of tangible goods and certain services. Businesses that do not collect sales tax on their products or services are being scrutinized by the Florida Department of Revenue for sales tax audits. Service providers often make large purchases of supplies, many of which are purchased from another state, for their business. Purchases made from out-of-state may also require your business to accrue and pay use tax, a complementary state tax that is applied in the same manner as sales tax (including discretionary sales surtax). Use tax is due on purchases that are made out-of-state and brought into Florida within six months of the purchase date. Use taxes can add up - you may need to do some strategic planning to reduce your overhead and yet maintain compliance with the sales and use tax laws.

## Solutions and Refunds

What can you do to minimize your company's tax exposure or, alternatively, to identify refund opportunities? You must keep complete and accurate records of all sales and purchases, whether taxable or not. These records may include general ledgers and journals, cash receipt and disbursement journals, purchase and sales journals, invoices and statements. You may also want to conduct a reverse audit to identify missed opportunities and refund potential. If you have overpaid sales and use tax, you may apply for a refund. The state does not notify you when overpayments have been made. To claim a refund or credit, supporting documentation must be sent in with the refund application.

# Our three-phase approach

At Daszkal Bolton, we have a proven track record in helping clients identify refund opportunities and minimize total tax liability. We can analyze your historical exposure to sales and use taxes. We can forecast prospective tax exposure and make recommendations to minimize your tax liability. We may also suggest the restructuring of your business operations as one way to reduce future taxes in certain situations. Conversely, we will determine if your company has unknowingly made overpayments, and we will seek refunds on your behalf.

Because every company is unique, we use a comprehensive phase approach to ensure that we cover all of the bases in our SALT engagements:

## **Phase I – Initial Consultation**

This phase focuses on your company's current sales and use tax practices, allowing us to identify potential tax savings opportunities and sales and use tax exposures. Phase I concludes with an oral presentation of our findings, which may include risks or opportunities associated with:

- Purchasing policies
- Retail sale procedures
- Fixed assets
- Tracking systems
- Sales and use tax compliance

## **Phase II – In-depth Analysis**

This phase includes an analysis of the potential sales tax strategies and exposures identified in Phase I as well as any other alternatives that are uncovered as a result of the more detailed analytical review. During this phase, tax savings and/or refund opportunities will be quantified. Phase II concludes with a detailed written account and/or presentation of our findings and recommendations, which may include:

- Improved internal purchasing and retail policies to ensure compliance
- Credits or incentives to improve your cash flow
- Restructuring business operations to minimize state and local taxes
- Full reverse audit to identify missed opportunities and refund potential

## **Phase III – Implementation of Tax Strategies**

This phase involves comprehensive assistance to your company in order to implement the strategies identified during Phase II. We will walk you through each recommendation until it is successfully implemented and properly in place to protect your company in the future and minimize your total liability.

Each of the above phases is strategically developed for your company based on your specific industry, historical sales tax behavior and the nature of your business. We will explain our procedures for each phase prior to engagement to ensure that you fully understand the process. We will rely upon your cooperation and look forward to working with you and your staff to minimize your tax liability.

# State tax technical ruling: a case study

## **Company Background:**

This manufacturing company is engaged in the business of fabrication, installation and sales of stairs, railings and banisters. The company's customers are primarily home builders, and all work is performed in Florida. All work is considered part of the real property upon installation, and removal would cause significant damage to the structures. This company had grown considerably over recent years. The company's owners, a married couple, were responsible for handling all tax and administrative matters for the company, including sales tax compliance.

## **Issues:**

This company had never had an in-depth internal sales tax review. The client was growing quickly, making significant purchases of supplies from outside of Florida and was unfamiliar with the state's treatment of purchases from out-of-state vendors. In addition, due to the multitude of sales tax compliance issues facing manufacturers, there was a growing concern by Daszkal Bolton that the company had significant exposure for underpayment of sales and use taxes in Florida. Accordingly, the client engaged us to conduct a Sales and Use Tax Compliance Review.

## **Solution:**

An in-depth compliance review by Daszkal Bolton led to the conclusion that sales and use taxes were not being accrued and remitted properly to the state of Florida. However, there was little guidance on the tax treatment of some of the unique issues that face manufacturers. We determined that their tax exposure was approximately \$300,000. Due to the significant tax exposure to the company and the scarcity of tax guidance on the issues presented, as part of the result of our compliance review, we recommended that we submit a request for a technical ruling from the Florida Department of Revenue on the client's behalf. Daszkal Bolton submitted the ruling on a no-name basis and the state provided an in-depth response to the technical questions presented. The company was then able to rely upon the ruling, referred to as a Letter of Technical Assistance (LTA), to properly assess the sales taxability of the various components of its business. After the client received the ruling, Daszkal Bolton recommended a plan of implementation to ensure compliance going forward. In addition, since the written guidance by Florida was specific to their business, the company had the extra comfort level of having a written document from the Florida Department of Revenue.

# Sales tax review and amnesty: a case study

## **Company Background:**

This telecommunications company is engaged in the business of selling various types of telecommunications services in the United States and Globally. The company is headquartered in New York and all telecommunications services originate from the company's New York locations. The company provides a broad range of services including internet access, dedicated T-1 lines and local New York telephone lines just to name a few. The company's administrative and tax personnel were relocated to Florida several years ago. That small staff is responsible for addressing the various state compliance and technical matters facing the company.

## **Issues:**

The company had not reviewed its state tax nexus and filing responsibilities in several years, particularly since the relocation of its administrative and tax personnel to Florida. Telecommunications companies must deal with a myriad of state sales tax and telecommunications tax rules that are often complicated and very difficult to understand. With a small staff to handle all the tax matters for the company, the company contacted us to assist with some of its state tax matters.

## **Solution:**

Our initial engagement focused on a review of the company's state nexus filings and to review certain taxability issues relating to the taxability of the purchase of equipment with a potential tax liability of approximately \$100,000. Based upon our conclusions to the client, they saved almost \$100,000 in New York state sales tax.

As we developed our relationship with the client, our state tax services expanded to include a state sales tax matrix for all the products they provide. In addition, we recommended that the client request a voluntary disclosure to New York on a taxability issue. A voluntary disclosure encompasses a letter that we send to a state taxing authority disclosing our client's activities on an anonymous basis and request a full waiver of penalties in exchange for disclosing the client's identity and filing all delinquent returns. Our relationship has evolved to the point where the company relies on us as its state tax advisor on all state tax matters.

# Due diligence: a case study

## **Company Background:**

A commercial furniture manufacturer and retailer contracted to sell a portion of its business to an existing Daszkal Bolton client. The furniture company is a multi-state company that conducts business in approximately 30 states. The company is headquartered in Florida and all manufacturing activities take place at its Florida headquarters. The company manufactures its products according to the specifications of its clients. Thereafter, the furniture is shipped to the destination of installation. The furniture is installed by the company through its own personnel or through independent contractors.

## **Issues:**

The entity acquiring the stock of the company contacted us to perform the due diligence on the acquisition. During the course of the due diligence, our client, in conjunction with our audit team, determined that a state tax due diligence review was required. The company had not reviewed its state tax nexus and filing responsibilities in several years. In addition, the company had a small staff to handle the state tax filings for the company. The concern by our client was proper collection procedures by the company as well as nexus for income tax as well as sales tax purposes. In addition, there was concern over sales tax collection policies that were in place at that time.

## **Solution:**

Our initial engagement focused exclusively on the state tax due diligence review. The state tax review entailed state tax research in over ten states, as well as meeting with personnel from the company regarding state filings. Our goal was to assess the filing responsibilities and then to provide a high-level sales tax exposure analysis for our client. We concluded that the company appeared to be in full compliance with Florida sales taxes. However, since the company relied on its customers to remit use tax, we had no method to verify such payments. We recommended that the company follow up with largest customers to ensure proper compliance with sales taxes. We also made a number of other recommendations, including reviewing potential income tax nexus issues relating states in which the company may be subject to income tax filing requirements.

As we developed our relationship with our new client after the due diligence was complete, the company engaged us to review many of the state tax issues identified on the due diligence. We also were responsible for registering the company for sales and use taxes in those jurisdictions we determined such filings were required. We have helped the company address various state and local tax issues and we also provide ongoing tax consultation and research for the company. We continue to be an ongoing resource for the company as it relates to state and local tax matters.

# Audit defense: a case study

## **Company Background:**

This company is a retailer/reseller of mobile satellite service, equipment and accessories for industry and individuals who are located throughout the world. The company is headquartered in Florida and has no other offices in the United States. Historically, the company collected sales tax for products and services sold to customers located in Florida only in accordance with Florida sales tax laws. Our client was recently contacted for a Florida sales and use tax audit.

## **Issues:**

When the client was initially contacted about a sales tax audit, the company was concerned about its internal sales and use tax policies and procedures. In addition, during recent years, there have been many changes concerning the taxability of telecommunications products and services as well as the method to calculate the sales tax due. Moreover, In addition, a new Florida tax was created several years ago referred to as the Communications Services Tax (CST), which although designed to simplify telecom compliance, has only served to confuse taxpayers since its inception. When the client contacted us, we explained to the company that we have a longstanding relationship with the local offices of the Florida Department of Revenue. Our relationship and history with the Department has led to smooth audits and generally penalty abatements. The company engaged us to handle the audit.

## **Solution:**

Our initial engagement was focused exclusively on the sales tax audit. We were the primary contact with the auditor and addressed all issues that arose on audit. The client helped to make the audit run smoothly as its employees provided all information required by the auditor in an organized and easy to understand manner. We also discussed all potential issues with the client up-front so there were no surprises during the audit. The initial assessment was over \$200,000 in tax due plus interest and penalties. We were successful in reducing that assessment of over \$200,000 down to under \$80,000. Our success was due in part to winning on some technical issues as well as requesting that the auditor re-assess certain assumptions made during the audit. In addition, the proposed penalty of \$40,000 was waived in full.

# Income tax nexus review: a case study

## **Company Background:**

This real estate company conducts business in multiple states through the ownership of real property and tax liens securing real property. Based upon the structure of the company, it has both corporate and personal income tax filing issues. Historically, the client filed income tax returns only in certain states where there was actual real property ownership.

## **Issues:**

The client historically filed in states where there was property ownership only. In those states where the client held a lien secure by real property, the client did not file any corporate returns or personal income tax returns. During the course of a client meeting, the issue of income tax nexus in other states was raised. Income tax nexus refers to the amount and degree of business activity that must be present before a state can tax an entity's income. The client became very concerned about compliance with other states particularly since the company had held tax liens in some of these states for a number of years.

## **Solution:**

Our engagement was focused upon a detailed review of the activities by the company in other states. We analyzed the client's business activities in other states as well as the nature of the real property owned in those other states. While it is clear that the ownership of real property in other states creates income tax nexus, it was not so clear that the ownership of a lien secured by real property was sufficient to create an income tax filing requirement. Our review concluded with oral communications with state taxing authorities on these complex issues. Our analysis was complicated by the fact that there is little uniformity in the states. We concluded by providing the client a detailed report of the states in which it was required to file both corporate and personal income tax returns. As a result of that engagement, we have provided ongoing advice and consultation on state tax matters on a going forward basis.

# Sales tax compliance review: a case study

## **Company Background:**

This retailer owns stores located in hotels throughout the country and primarily sells clothing, health and beauty supplies and food and beverages. The client has over 300 stores and conducts business in over thirty (30) states. The client is privately owned and does not have a dedicated employee responsible for handling sales and tax compliance matters. Our client was contacted by the State X for a state sales and use tax audit.

## **Issues:**

When the client was initially contacted for the state sales and use tax audit, the company was concerned about its audit exposure in State X as well as its own internal state sales and use tax compliance procedures and policies. The company had not conducted a state sales and use tax review in several years, nor had the company reviewed the proper tax treatment of its products, the tax treatment of which differs in many states. In addition, the company had not been accruing use tax on purchases of fixed assets or supplies for its business. When the client initially contacted us, we were engaged to provide audit defense assistance. We also recommended that the client allow us to conduct a Phase I State tax review of their business. The client agreed to a Phase I state sales tax review to better understand what issues the company faced from a state sales and use tax standpoint.

## **Solution:**

The audit was very lengthy and many issues of overall compliance arose. We were the primary contact with the auditor and addressed all issues raised. The audit ended with a substantial refund to the client based upon an error in calculating the sales tax due State X correctly. In addition, we conducted the Phase I Review and presented our findings to the client. Based upon our findings in Phase I, the client engaged us to conduct a more comprehensive Phase II in-depth review and implement our recommendations. We helped the client with taxability issues in the various states as well as implement a process whereby the client accrues use tax on a monthly basis. We continue to provide ongoing tax guidance to the client in the area of state sales and use taxation.

# Due diligence: a case study

## **Company Background:**

Company engaged in the manufacture and sale of food products with four divisions. The manufacturer is headquartered in Florida and its manufacturing plants are all located in Florida. Manufacturer contracted to sell three of its four divisions to a Purchaser located outside of Florida. The company was referred to our state and local tax specialist by an attorney at a law firm for which Daszkal Bolton LLP has had a longstanding relationship.

## **Issues:**

The entity selling the assets contacted us to review the state sales tax consequences related to the sale of its assets Purchaser, located outside of Florida. Specifically, our client requested that we review the taxability of the transaction for Florida sales tax purposes, apart from the transfer of inventory and motor vehicles. In addition, we reviewed the sales taxability of the transfer of the motor vehicles and inventory. Since Purchaser was located outside of Florida, the company was concerned that Florida sales tax issues were not being addressed. In addition, Purchaser was not registered for Florida Sales tax purposes.

## **Solution:**

Our engagement focused upon the taxability issues as well as Florida sales tax filing requirements for both our client as well as the purchaser. We worked with the company to gain a full understanding of all assets to be sold and concluded that the sale of assets, with the exception of motor vehicles and inventory was not subject to sales tax as an exempt isolated sale. The business assets consisted of machinery and equipment, computer equipment, office furniture and fixtures and telephone equipment. The client was surprised by some of the other results of our review. First, the sale of trailers was subject to Florida sales tax since the sale of motor vehicles did not qualify for isolated sales treatment. Second, the transfer of inventory other than food products and [packaging materials was only exempt from tax if the purchaser was registered in the state of Florida and supplied the seller with a valid Florida resale certificate. Our state tax due diligence led to additional federal tax issues which we assisted with resolution of those issues as well.

# Documentary stamp tax research: a case study

## **Company Background:**

Our firm was contacted by an attorney that was assisting his client with a restructuring involving the transfer of property subject to a mortgage as well as adding an obligor to an existing note secured by a mortgage. The attorney wanted to structure the deal so as to minimize and/or eliminate documentary stamp taxes, which can quite substantial on refinancing transactions. The client (attorney) was referred to our state and local tax specialist by another attorney at a law firm for which Daszkal Bolton LLP has had a longstanding relationship.

## **Issues:**

The client contacted us to assist in the structure of a refinancing to avoid or minimize state documentary stamp taxes. Specifically, we reviewed certain state tax issues including the application of the Florida documentary stamp tax to the conveyance of property subject to a mortgage an individual to a newly formed entity and the addition of an obligor to an existing note secured by a mortgage. The individual's bank was requiring the transfer of the property to an entity rather than remaining in the name of the individual. In addition, the new entity's name would be added to an existing note.

## **Solution:**

Our engagement focused upon the taxability of the transactions contemplated as well as ways in which to reduce taxes. The transactions, as originally structured, would have resulted in significant liability for documentary stamp taxes. We analyzed the entire transaction and researched the taxability of the structure as is. Thereafter, we recommended an alternative structure through use of a trust to eliminate a significant portion of the liability. The result was very positive and we have developed a good relationship with the attorney.

# New pro-manufacturing bills reduce taxes

August 2006

Florida manufacturers have secured a big win with the passage of two new pro-manufacturing bills. The May 2006 Florida Legislative Session was considered one of the most victorious sessions in history for the Florida manufacturing industry. Legislation was passed that will better position Florida's manufacturers to compete regionally, nationally and globally. One bill eliminates sales tax payments on machinery and equipment used in a manufacturing capacity for expansion or growth. The other bill eliminates sales tax payments on machinery and equipment used in research and development. The tax exemptions, which became effective on July 1, 2006, affect over 16,000 manufacturers in Florida, primarily small businesses, which collectively employ close to 400,000 people.

## **Purchases by Expanding Manufacturers**

The law grants a full sales tax exemption to manufacturers for the purchase of industrial machinery and equipment when expanding productive output by at least 10%. Prior to July 1, 2006, expanding manufacturing businesses were required to meet a \$50,000 tax threshold. That translated into approximately \$800,000 in purchases of new equipment. Purchase transactions completed, or lease payments required to be made, prior to July 1, 2006, remain subject to the previous tax threshold.

In addition, expanding manufacturing businesses that purchase or lease qualifying machinery and equipment for use under a federal procurement contract are no longer required to meet a \$100,000 tax threshold. Purchase transactions completed, or lease payments required to be made, prior to July 1, 2006, remain subject to the \$100,000 tax threshold.

To qualify for the exemption from sales tax, manufacturers are still required to show an increase in productive output of not less than 10 percent. Purchasers must submit Form DR-1214, Application for Temporary Tax Permit, with the Department of Revenue.

## **Purchases for Research and Development**

The law also exempts purchases or leases of machinery and equipment that will be used predominantly in research and development activities. The term "predominantly" means at least 50 percent of the time. The purchaser must continue to issue an exemption certificate or a direct pay permit to the selling dealer in order to purchase the qualifying machinery and equipment on a tax exempt basis.

Sample exemption affidavits, available through the State of Florida, can be tailored with the help of your trusted advisor to fit your company. It needs to attest to the fact that the equipment you are purchasing will be used predominantly for research and development. It is a different exemption certificate than a resale certificate and does not count as a blanket exemption from sales tax.

## **Manufacturers Are Still Subject to Florida Sales Tax**

Manufacturers are, nonetheless, prime targets for sales and use tax audits. The truth is that manufacturers still face a myriad of complex sales tax rules which can often make even the most seasoned tax expert grimace.

The sales/use tax issues are complex. There is a tremendous amount of inconsistency between states and the issues are too complex to anticipate streamlined federal legislation in the near future. Contact us to discuss your current situation. Our trusted advisors are available to guide you through the myriad of tax codes, rules, case law, and regulations.

# Will the SSTP affect your bottom line?

February 2006

Ever since the Internet gained wide acceptance as a sales tool, there has been an ongoing debate in our country with the individual states on one side and retailers and other business entities on the other. Individual states, particularly those that are starved for new sources of revenue (like Florida), argue that online sellers of property are responsible for collecting and remitting state sales tax. Sellers of products and services online maintain that those sales should be exempt from sales tax. Currently, there is no national law providing guidance in the marketplace.

It has been estimated that state and local governments missed out on \$18 billion of online sales in 2005. Any concrete resolution of this issue will have an enormous impact on the business sector. The repercussions will be felt by manufacturers of products and other vendors and suppliers, as well as direct online sellers.

To date, the most significant development in this area has been the implementation of the Streamlined Sales Tax Project—commonly referred to as the “SSTP.” This controversial plan went into effect on October 1, 2005.

## What is the SSTP?

Briefly stated, it is a computerized program that tracks the sales tax rates of various states and their localities. The SSTP automatically adds the appropriate sales tax to all online purchases by residents in those states. As part of the overall project, the individual states have been encouraged to offer retailers amnesty on taxes that have not been collected from online sales.

Many of the states have revised their own laws to eliminate some of the confusion and provide greater uniformity concerning categories for sales tax. For example, in some states, candy is treated as a food item; in others, it is not. Thus, candy may be subject to a higher or lower sales tax. The new project is aimed at erasing those kinds of distinctions.

Previously, online merchants sought to avoid sales tax collections by relying on a landmark 1992 Supreme Court ruling, which stated that it would be too difficult for retailers to calculate all the possible permutations of the various states. The SSTP is seeking to overcome that objection.

One of the key points of the SSTP is to tax online retail sales at the customer’s destination rather than the purchase location. This decision has been hotly debated by detractors and proponents.

## Who is affected by the SSTP?

Currently, the 19 states that have agreed to participate in the SSTP are Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Utah, Wisconsin and Wyoming. Florida has not yet indicated its intention to become part of the SSTP, but my sources say that the change may be coming sooner rather than later.

## What does the signing of the SSTP signify?

For many state tax analysts, the move represents a dramatic first step by those nineteen states to require their states to convince retailers to collect sales tax on sales made over the internet. But, the SSTP was designed for sales tax compliance and simplification and administration. It also represents a symbolic step for something much greater to state sales tax collection.

The end game is bringing in much needed tax revenues for the states participating in the SSTP. But will the states get what they want? Some state tax analysts feel the program ultimately will generate that revenue to the states. There is already a tremendous push for states to bring in additional revenue. The states are hungry for it and the federal government keeps cutting back on funding to the states. Although there are complications with the SSTP, such as the voluntary participation in the program, the National Retail Federation and the National Governors Association want Congress to mandate participation. The bottom line is: Now is the time to review your procedures for sales and use tax collections, particularly if you are a retailer that does business via the Internet.

# Income tax nexus: aggressive tax collection

September 2005

State corporate income taxes have become the subject of renewed interest to both state and federal policymakers for primarily two reasons: interstate commerce and tax interaction. At the heart of the debate is nexus, which describes the amount and degree of business activity that must be present before a state can tax an entity's income. Unfortunately, there is significant variation from state to state in how physical presence, a determining factor in establishing nexus, is defined. A recent ruling deems that physical presence is unnecessary for the taxation of intangible property.

Interstate commerce oversight and tax interaction issues are of interest to policymakers for three principal reasons: (1) the complex internet sales tax debate; (2) the recent federal business tax cuts; and (3) state fiscal issues. The link between the internet sales tax debate and state corporate income taxes is complicated and centers on the states' inability to reach beyond their borders to compel out-of-state vendors to collect sales and use taxes. As a general rule, a state can require a vendor to collect sales and use taxes only if the vendor has substantial nexus in the state. Typically, the substantial nexus standard is satisfied if the vendor has a physical presence in the state. Thus, remote internet transactions, where the vendor has no physical presence in the customer's home state, do not have the sales and use tax added to the price of the good by the vendor. These types of transactions have grown considerably over the last several years and have contributed to the erosion of the sales and use tax base of most states, urging those states to take a more aggressive stance on the collection of lost revenues.

Legislation was introduced in the 108th Congress that would have addressed some of the issues identified above. Nexus issues were addressed in what was identified as "streamlining" legislation. Legislation was also introduced that would have addressed nexus issues for state corporate income taxes directly - sometimes identified as "bright line" legislation - that would establish more uniform (and higher) standards for the level of business activity that would trigger nexus and thus corporate income taxability. These issues continue to be unresolved and will continue to be focused on in the near future at all levels of government. You need to be aware of changes that are made and how they affect your business. Comprehensive tax planning is your best defense against the newly aggressive state tax collection campaigns and potential future tax legislation on a federal level.

**What is Nexus?** - Nexus describes the amount and degree of business activity that must be present before a state can tax an entity's income. If you have nexus in a particular state, you must pay and collect/remit taxes in that state. In general, nexus is created for income tax purposes if an entity derives income from sources within the state, owns or leases property in the state, employs personnel in the state in activities that exceed "mere solicitation," or has capital or property in the state. The amount of activity or connection that is necessary to create nexus is defined by state statute or case law and/or regulation and, consequently, tends to vary from state to state. However, all states are limited by Constitutional principles, judicial doctrine and federal law.

**Physical Presence** - Historically, cases brought before the US Supreme Court relating to nexus involved factual situations in which the taxpayer had a degree of physical presence in the state seeking to impose its tax. In *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), the US Supreme Court ruled that the Commerce Clause mandated that, absent action by Congress to the contrary, a taxpayer must have some physical presence in a state to be subject to collection responsibility for the state's use tax. Although *Quill* deals with use tax, the Court's discussion of the general Due Process and Commerce Clause Constitutional principles of nexus opinion sheds some light on their application to franchise and income taxes.

The South Carolina Supreme Court, in *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993) held that a Delaware holding company that owned only intangible property used in South Carolina was subject to income tax. The court rejected Geoffrey's claim that it had not purposefully directed its activities toward South Carolina's economic forum and had minimum connection and nexus with South Carolina. Many states have incorporated the principles of nexus outlined in *Geoffrey* through statute or regulation.

**Lanco, Inc. v. Director, Division of Taxation** - A recent ruling (August 24, 2005) from the New Jersey Superior Court indicates that the lack of physical presence does not necessarily negate nexus: physical presence was deemed unnecessary for the taxation of intangible property (in this case, trademark licensing fees). The New Jersey corporation business tax was constitutionally applied to income derived by a Delaware corporation from the licensing of trademarks, trade names, and service marks to a New Jersey clothing retailer, even though the corporation had no offices, employees, or real or tangible property in the state. This is merely an example of what we can assume will become more prevalent in the future, and may likely begin to affect Florida business owners.

There is a tremendous amount of inconsistency between states and the issues are too complex to anticipate "streamlined" federal legislation in the near future. Take our abbreviated Nexus Questionnaire to see if any of the multi-state issues involving nexus, corporate income tax, or sales/use tax apply to you.

# Are you overpaying sales tax on your rent?

July 2004

Do you rent office space or other real property in Florida? Are you in an owner occupied building? Do you rent space in a building in which you own? Are you paying sales tax for that rental of space from your landlord? Is your business (the tenant) related to the owner of the building (the landlord)? If you answered yes to any of these questions, then read on to find out whether you should be paying sales tax on the rental of that space.

Florida sales tax is imposed on all rent paid for the right to use or occupy commercial real property, unless otherwise specifically exempt. Some examples of commercial real property rentals that are subject to sales tax include office or retail space, warehouses, convention and meeting rooms and mini-warehouses. Often, this tax is referred to as a "commercial rentals tax." The tax is imposed at the rate of six (6) percent on all rental payments, which may include charges for ad valorem taxes (whether paid to the landlord or directly to the county tax collector's office), common area maintenance, customer (free) parking, or janitorial services.

Florida's exemption from the commercial rental tax is quite limited. A few examples of rentals exempt from tax include:

- Rentals of real property classified as agricultural;
- Rental property used exclusively as dwelling units;
- Commercial rentals to non-profit organizations that hold a Florida Certificate of Exemption;

Florida has no intercompany sales tax exemption for sales tax purposes. Thus, rentals of real property by related persons are also subject to sales tax. Examples of related party rentals include the rental from a parent corporation to a subsidiary, or individual/shareholder to a corporation. In addition, sales tax is imposed on leasing transactions between an LLC and its members.

Are all related party or intercompany leases subject to sales tax? Perhaps not. If a related party transaction is not really a true lease but a financing arrangement that is more akin to a mortgage, then sales tax does not apply. The Florida Department of Revenue has recognized that under certain circumstances, for tax purposes, a document structured as a lease may be treated as mortgage. In the famous case of *Bridgestone/Firestone, Inc. v. Department of Revenue (1993)*, a sale-leaseback transaction was examined, and the court determined that, although a document may be called a lease on its face, one must look to the intention of the parties entering into the agreement to ascertain the true nature of the transaction. The criteria that the state looks at is whether there is a Lessor/Lessee relationship including the following factors:

1. Is the rent arm's length or reflective of a mortgage or interest payment?
2. Does the Lessee have the ability to purchase the property for amounts due to the lender?
3. Is the loan secured by the Lessee?
4. Was the "Lessor" created merely as a single purpose finance entity? and
5. Does the Lessor have any substance or merely a shell entity for holding real estate?

The foregoing factors are merely a few of the factors the state may review in making a determination. Please note that each case is very fact sensitive and often the state requires the taxpayer to request a ruling for any written guidance.

What can be done to ensure compliance with Florida sales tax rules regarding leases of real property? We will begin by reviewing your intercompany arrangement and advising you on whether it is a taxable lease, exempt from tax under one of the exemptions or completely exempt as a financing arrangement.

# Florida sales and use taxes: risks & refunds

June 2003

Tax evasion, traditionally associated with federal income taxes, has reached the state sales and use tax arena. Uncollected sales and use taxes were estimated in the billions of dollars for the year 2003, and the figure appears to be increasing exponentially. In today's uncertain economic climate, states are feeling the revenue pinch. Florida is already seeking new ways to raise revenue and is focusing on sales and use taxes. Now is the time to make sure you are in compliance with sales and use tax laws.

## What is "Use Tax"?

Use tax is similar to sales tax and is filed using the same sales and use tax return with which most business people are all too familiar. The primary application of use tax is to tax goods that are brought into Florida untaxed or taxed at a rate less than the Florida sales tax rate. The tax is designed to ensure that all purchases are taxed, whether they were obtained locally, through mail-order catalogs, over the Internet or from out-of-state vendors.

## Use Tax Rules to Know

It is a common misconception that purchasers are only obligated to pay sales tax when the merchant includes tax on the invoice or bill. If no tax is charged, it is assumed that no tax is due. Be careful! This assumption could get you into financial trouble. When a merchant is located out-of-state and is not required to collect sales tax from Florida purchasers, charges less than the state's sales tax rate or simply fails to charge sales tax, you are responsible for payment of use tax on the purchase.

Most business supplies are taxable, with few industry-related exceptions (for example, paper is tax-exempt when purchased by a publishing company for the production of a magazine that will be taxed upon resale). Do you know which of your supplies are taxable and which are exempt? Like other business owners, you may utilize the Internet and mail-order catalogs to purchase business supplies. Many e-merchants and out-of-state catalog companies do not include sales tax on their invoices. Perhaps you purchase supplies directly from a wholesaler or retailer headquartered in another state. These purchases are taxable and you are responsible for paying the use tax on them.

What about purchases that were tax-exempt upon purchase because they were going to be resold or used for the production of a product (like the example above), but ended up being used by you or your company? Those purchases are also taxable once they have been used for internal purposes rather than a resale product. Knowing which supplies are taxable and which are exempt is key to maintaining compliance with the sales and use tax laws.

## Consequences of Non-Compliance

Use taxes can add up for small to mid-size businesses. By failing to pay these taxes, you could put your company in financial jeopardy. The state of Florida can go back three years to collect unpaid use taxes, plus interest and penalties, for any business that has filed a sales and use tax return. For companies that have never filed this return, the state may go back to the inception of the business to collect back taxes. For example, if you have been in business for ten years and have made taxable purchases from out-of-state vendors without paying sales or use tax, the state can collect ten years' worth of unpaid use taxes, plus interest and penalties.

## Solutions and Refunds

What can you do to minimize your company's tax exposure or, alternatively, to identify refund opportunities? Complete and accurate records of all sales and purchases, whether taxable or not, must be kept. These records may include general ledgers and journals, cash receipt and disbursement journals, purchase and sales journals, invoices and statements.

You may apply for a refund if you have overpaid sales and use tax. The state will not notify you when overpayments have been made. To claim a refund or credit, supporting documentation must be sent in with the refund application, which we would be happy to assist you in preparing.

# Faith L. Gorman, JD

Faith is the Director of our State and Local Tax Practice. She is a nationally-recognized expert in state and local taxation, with a primary focus on income/franchise and sales and use taxation. She provides consultations for the purpose of limiting the state tax impact of corporate decisions and activities. Faith concentrates on state and local tax issues for middle market multi-state corporations, including nexus/jurisdiction for tax, affiliate nexus, discriminatory taxation, unitary business principal, gross receipts definition, and apportionment issues. She also represents individuals and corporations in state and local audit defense. Faith has been qualified as an expert witness in state and local tax matters and provides testimony at depositions and trials in Broward, Dade and Palm Beach County.



Faith assists companies in restructuring their management operations to minimize state and local income taxes. She has successfully reduced large state sales tax assessments and frequently discovers overpayments of sales tax through her analyses. Faith also provides assistance for mergers, acquisitions and dispositions with multi-state interests. In addition, she negotiates with governmental authorities to secure exemptions for purchases of manufacturing machinery and equipment, and seeks tax incentives and tax credits.

Faith has published numerous articles in the state and local tax arena and has contributed to several newsletters and publications. She serves as a liaison to the media as a state and local tax expert.

Prior to joining Daszkal Bolton, Faith worked as a Senior Tax Manager for the Washington National Tax practice of KPMG LLP. Previously a Senior Tax Manager with Ernst & Young, she was responsible for developing and expanding a multi-state tax practice in South Florida.

Faith earned a Bachelor of Arts degree at Brandeis University and a Juris Doctorate degree at Hofstra University's School of Law.