

## States' Nexus Claim Assertions: Responding to State Income Tax Liability Challenges

THURSDAY, JANUARY 20, 2022, 1:00-2:50 pm Eastern

### IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 ext. 1 (or 404-881-1141 ext. 1). Strafford accepts American Express, Visa, MasterCard, Discover.
- Listen on-line via your computer speakers.
- Respond to five prompts during the program plus a single verification code.
- To earn full credit, you must remain connected for the entire program.

### WHO TO CONTACT DURING THE LIVE PROGRAM

#### For Additional Registrations:

-Call Strafford Customer Service 1-800-926-7926 x1 (or 404-881-1141 x1)

#### For Assistance During the Live Program:

-On the web, use the Chat function to send a message

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

## *Tips for Optimal Quality*

FOR LIVE PROGRAM ONLY

---

### Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail [sound@straffordpub.com](mailto:sound@straffordpub.com) immediately so we can address the problem.

---

**Recording our programs is not permitted. However, today's participants can order a recorded version of this event at a special attendee price. Please call Customer Service at 800-926-7926 ext.1 or visit Strafford's website at [www.straffordpub.com](http://www.straffordpub.com).**

# **States' Nexus Claim Assertions: Responding to State Income Tax Liability Challenges**

---

January 20, 2022

---

George W. Rendziperis, JD  
Principal, SALT  
REDW  
[george.rendziperis@redw.com](mailto:george.rendziperis@redw.com)

Jeanna Schenk, CPA, MST  
SALT Manager  
REDW  
[jeanna.schenk@redw.com](mailto:jeanna.schenk@redw.com)

# Notice

---

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.



# STATE AND LOCAL TAX

# Controversy

# JEANNA SCHENK, CPA



Jeanna is a SALT manager at REDW. Her prior work history is in both public accounting and publicly traded companies. She has 10 years of experience in state income tax compliance and research, state income tax provisions, and managing state income tax audits.

# GEORGE W. RENDZIPERIS, JD



George is a Principal at REDW. He provides state and local tax advice to companies in the oil and gas, manufacturing, financial services, private equity, real estate, technology and service sectors. He has more than 15 years of experience advising clients on controversy, litigation, planning, implementation and compliance issues related to income and franchise tax, sales and use tax, excise and property taxes, unclaimed property, and tax incentives and credits.

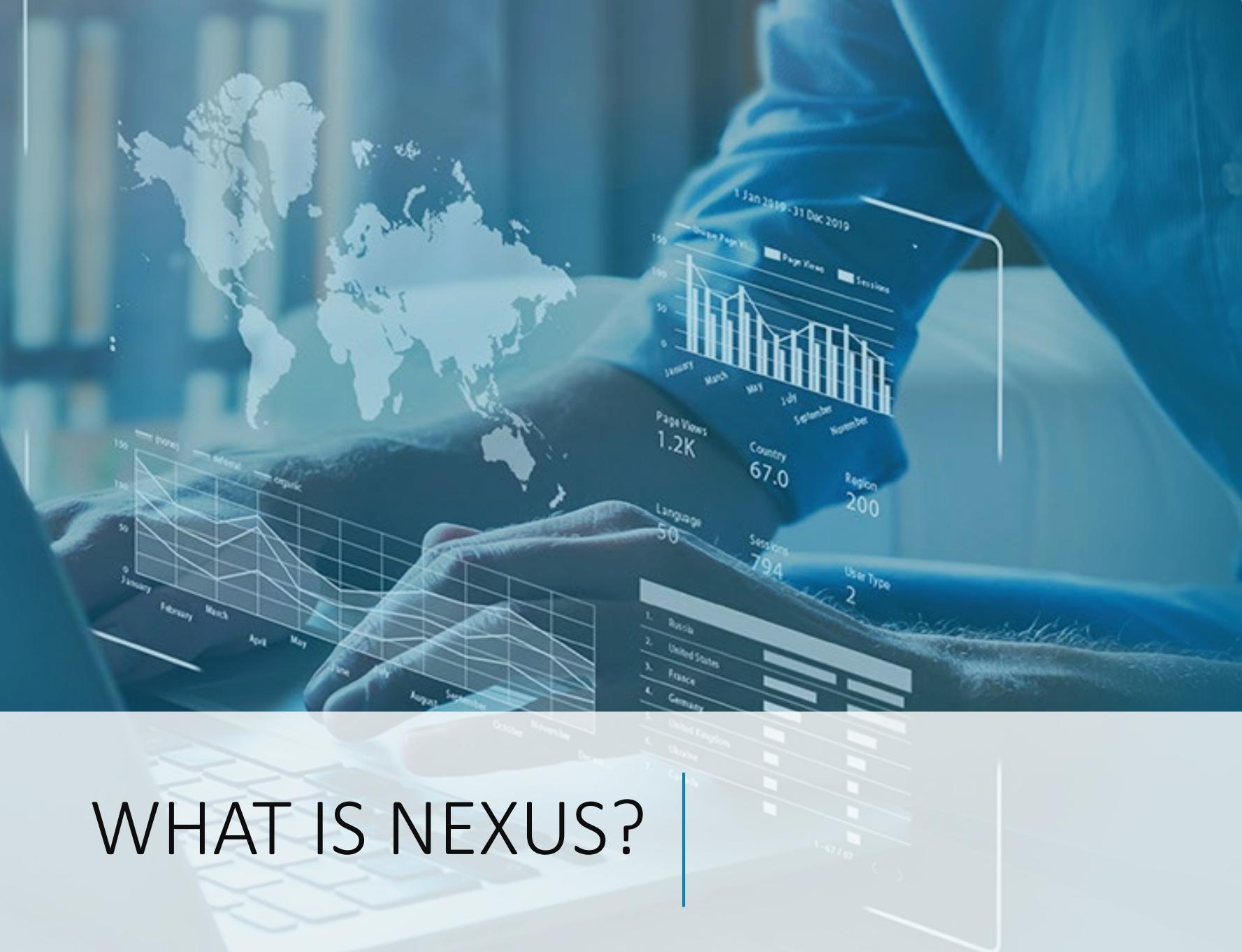
# OVERVIEW AND LEARNING OBJECTIVES

- What is Nexus
- Why is Nexus important
- How is Nexus created for state income tax purposes and sales and use tax purposes
- When Nexus is created, what must be done to be compliant with state law
- Understanding the state tax audit process
- State specifics: California, New York, Texas



# TAKE AWAY

- State agencies or departments (units) are sharing information
  - Example
    - Secretary of state and department of revenue
    - Withholding unit sharing information with income/franchise units
- States are sharing information with each other
- Audits have increased
  - Obtaining information via audits of other taxpayers
- Budgetary deficits
  - Narrow the gap by:
    - Increasing the tax base
      - Tax more services
      - Cast a bigger net via nexus



# WHAT IS NEXUS, GENERALLY?

- Taxpayer's contact with a state
- General Observations
  - Services Maintaining an office in the state
  - Employees in the taxing state
    - Continuous, systematic and regular contact
    - Independent agent
  - Doing business within the state or certain amount of sales into the state
  - Owning property in the state
  - Deriving income from sources within the state

# INCOME/FRANCHISE/GROSS RECEIPTS NEXUS STANDARDS

- Physical presence
  - Employee, inventory or assets in the state
- Economic presence
  - *Geoffrey v. South Carolina* and the use of an intangible in a state
- Agency nexus
  - Activities of in-state person creates nexus due to “agency relationship”
- Affiliate nexus
  - Related companies
- Factor Presence Nexus
  - Meet a threshold of sales into the state
    - California - \$500,000 of sales
    - New York - \$1,000,000 of sales
    - Texas - \$500,000 of sales

# PUBLIC LAW 86-272

- Immunity from state ***income tax***
  - Solicitation
  - By an employee or representative
  - On orders for **tangible personal property**
  - Sent outside the state for approval
  - Filled by shipment or delivery from a point outside the state
- Limitation
  - Sale of intangible property
  - Activities connected with the sale of a service
  - Taxes not based on income

# WRIGLEY DECISION

- The Supreme Court of the United States held that, in addition to any speech or conduct that explicitly or implicitly proposes a sale, the term includes activities that are ancillary to requests for purchases. Solicitation does not include activities the company would have reason to engage in anyway, but has chosen to allocate to its in-state sales force. The Court illustrated the distinction with the following example:
  - Providing a car and a stock of free samples to sales representatives is part of the solicitation of orders because the only reason to do it is to facilitate requests for purchase
  - Employing sales representatives to repair or service the company's products is not part of the solicitation of orders because there is a reason to repair or service the products whether or not the company has a sales force. Repair and service may help to increase purchases, but they are not ancillary to requesting purchases and cannot be converted into solicitation merely by being assigned to sales representatives

# SALES AND USE TAXES NEXUS STANDARDS

- Prior to June 2018 and the Wayfair Decision - Physical presence in the state
  - In *Quill Corp. v. North Dakota*, the Supreme Court ruled that a business must have a physical presence in a state for that state to require it to collect sales taxes. However, the court explicitly stated that Congress can overrule the decision through legislation.
- Agency nexus (“click through”)
  - Example: New York – The New York law requires many Internet retailers operating “affiliate programs” in the state to charge sales tax on the retailer’s sales to New York residents. These affiliates — which can be local bloggers, newspapers, nonprofit organizations, and other types of businesses (i.e., agents) — post on their websites links to online retailers and receive a commission when purchases are made through those connections

# SALES AND USE TAXES NEXUS STANDARDS

- Affiliate nexus
  - Example: Texas – Texas has amended its law regarding sales and use tax nexus effective January 1, 2012 so that an out-of-state seller with substantial ownership in an affiliate doing business in Texas may now create nexus for that seller. Substantial ownership means the seller has 50 percent ownership in the affiliate whether the ownership is direct ownership, common ownership, or indirect ownership through a parent, subsidiary, or affiliate. Substantial ownership in an affiliate with a physical location where business is conducted in Texas will create nexus for a seller in an affiliated group
- After June 2018 and the Wayfair Decision – Changed the landscape in Sales and Use Taxes
  - South Dakota law which stated that a company will have nexus if such company:
    - has gross revenue from the sale of tangible personal property, any products transferred electronically, or services delivered into South Dakota exceeds \$100,000; or
    - 200 or more separate transactions of tangible personal property, any products transferred electronically, or services delivered
      - Note – most states are not enforcing the 200 transactions because there is no guidance on what is a transaction

# WAYFAIR'S IMPACT ON BUSINESSES

- Which jurisdictions should register/collect sales tax?
- What is the sales threshold for each jurisdiction?
- When does tax collection start?
- What tax rate should be charged?
- Can our company handle the new compliance burden?
- Should our company pay tax when purchasing items in new jurisdictions or is an exemption available?

# REMOTE EMPLOYEES AND COVID-19

- Does this create nexus?
  - Income/franchise/gross receipts taxes
  - Sales and use taxes
- Which state do I withhold income taxes?
  - New Hampshire vs Massachusetts
    - MA regulation - declaring that any income earned by a nonresident who used to work in Massachusetts but was now telecommuting from out of state "will continue to be treated as Massachusetts source income subject to personal income tax." Massachusetts was claiming the authority to tax income earned by persons who neither lived nor worked in Massachusetts
    - Supreme Court of the United States refused to hear the case
- States will have budgetary deficits and will be aggressive in enforcing nexus laws

# WE HAVE NEXUS WITH A STATE, NOW WHAT?

- Income Tax/Franchise Tax/ Gross Receipts Tax
  - Generally, file tax return
  - Review apportionment
    - Sales only; or sales plus property plus payroll
- Does 86-272 apply
  - Income tax
  - Sale of tangible personal property
- Sales and Use Taxes
  - Register with the state and begin collecting and remitting sales and use taxes on taxable sales
- Legal vs Practical approach
  - Risk threshold

# HOW WILL A STATE FIND US?

- Customers or vendors located in the State and such taxpayers are being audited by the state
- Online searches by the State
- Nexus questionnaire
  - Purpose
    - States determine if you have nexus with the state
    - Precludes a company from the Voluntary Disclosure process
  - How does a state get a company's name?
    - Through an audit of your customer or vendor
    - Searches on the internet
  - How to proceed if you receive a questionnaire
    - Do not ignore
    - State will assess tax
    - Penalties
  - Signed under the penalty of perjury





# WE HAVE NEXUS, HOW CAN WE GET COMPLIANT WITH STATE TAX LAWS

# VOLUNTARY DISCLOSURE/AMNESTY PROGRAMS

- These programs allow taxpayers to become compliant with state tax laws (e.g., income/franchise, sales and use, employment, individual (nonresident) income, unclaimed property)
- Under a voluntary disclosure program, it is an agreement between the taxpayer and the state where the individual voluntarily comes forward and agrees to submit delinquent returns and tax payments for a specified period of time. Generally, a voluntary disclosure request is made anonymously through a taxpayer's representative and may be negotiated by the taxpayer's representative for preferred terms
- Voluntary disclosure programs' requirements are generally as follows:
  - Taxpayer must come forth voluntarily; therefore, taxpayer must not have been notified by the state's department of revenue or be under audit
  - Limited look back period (generally 3 to 5 years)
  - Penalties are waived
  - Interest is not waived

# VOLUNTARY DISCLOSURE/AMNESTY PROGRAMS

- Under a tax amnesty program, taxpayers may come forward voluntarily and pay delinquent taxes. Generally, states will waive all penalties and may waive all or a portion of the interest. Tax amnesty programs are approved by the state's legislature and run for a limited time. Furthermore, unlike voluntarily disclosure, tax amnesty programs do not offer a limited look back period or the ability to negotiate preferred terms.



# STATE TAX CONTROVERSY AND BEST PRACTICE IN AUDIT MANAGEMENT

# NEXUS QUESTIONNAIRE

- Purposes
  - States determine if you have nexus with the state
    - Casting the big net
  - Precludes a company from the Voluntary Disclosure process
- How does a state get a company's name?
  - Through an audit of your customer or vendor
  - Searches on the internet
- How to proceed if you receive a questionnaire
  - Do not ignore
    - State will assess tax
    - Penalties
- Signed under the penalty of perjury

# AUDIT PROCESS

- Letter from state's department of revenue/treasury
  - Discussion with auditor regarding location and time of audit
    - Keep auditor away from the business premises; use accountant or attorney office to conduct audit
    - Need to manage audit
- Prior to audit beginning
  - Review records
    - Reconcile accounts
      - Make sure work-papers (trial balance, etc.) tie to tax returns/reports filed with the state
    - Obtain exemption certificates
    - Get organized, determine exposures or refund opportunities
- Open communication with auditor

# INCOME/FRANCHISE TAX AUDIT

- Auditor will request the following information
  - Trial balance
  - Financial statements
  - Federal tax return
  - Sales, property, payroll by state
  - Depreciation schedules
  - Tax workpapers
  - Corporate minutes
- Auditor will review
  - Company website
- The auditor will tie numbers to the federal return and trial balances

# SALES AND USE TAX AUDIT

- Auditor will request the following information
  - Chart of accounts
  - Contracts / job files
  - Financial statements
  - Resale / exemption certificates
  - Sales invoices
  - Computerized accounting records
  - Federal income tax returns and workpapers
  - Purchases invoices
  - Sales / use tax returns and workpapers

# SALES AND USE TAXES – TESTING AND SAMPLES

- Generally, sales and use tax audits are broken into four basic exams or homogenous groups/populations.
  - Sales
  - Cost of Goods Sold/Purchases
  - Fixed Assets
  - Expenses (General and Administrative/Indirect)
- Each exam will have its own generated error rate based on the stratified sampling.
  - Stratified Sampling Example:
    - Create dollar strata
    - \$0- \$1,000
    - \$1,001 - \$10,000
    - Items over \$10,000
  - Error rate is against its respective population only.
- NOTE: This process may vary based on the auditor's accessibility of records. If there are limitations, auditor will produce a reasonable method of auditing that may differ from above.



# BEST PRACTICE IN SETTLING A STATE TAX DISPUTE

# CONTESTING A DISAGREED AUDIT - TEXAS

- Audit complete
  - Reconciliation conference
    - After exit conference, but before Notification of Audit Results
    - Request meeting with auditor's manager or supervisor
      - Settle dispute – cannot settle dispute
- Independent audit review conference (IARC)
  - Informal meeting with a third party ( audit referee, employee of comptroller), taxpayer and auditor
    - Each side presents case and referee asks questions
    - Referee will provide written report to the comptroller regarding how to resolve the dispute
    - If you disagree with the referee's conclusion, then taxpayer will receive a Texas Notification of Audit Results (a/k/a 30 day letter)

# CONTESTING A DISAGREED AUDIT – TEXAS

(CONTINUED)

- Audit complete (cont.)
  - Redetermination Hearing
    - Have 90 days from date of Notification to request
    - Provide the comptroller a statement of grounds for such redetermination
    - Not required to pay assessment
      - If you miss the 90 day deadline, must pay assessment and proceed to District Court and request a refund
    - If you disagree with outcome:
      - Request the auditor to transfer case to the hearings division; or
      - Pay the claim “in protest” and file claim in district court

# CONTESTING A DISAGREED AUDIT – TEXAS

(CONTINUED)

- Audit complete (cont.)
  - Hearings (SOAH)
    - administrative appeal
      - Before administrative judge
      - Written submission or oral hearing (trial)
    - no need to pay to play
  - Filing a court case in District Court
    - Pay to play
    - Pay claim under protest

# HIRING A PROFESSIONAL

## – CPA OR ATTORNEY

- Why a hire a Professional
  - Manage audit
  - Communication with auditor
  - Contacts
  - Understanding of the law and new developments
- Comptroller's authority
  - Freezing assets
    - Notification to taxpayer is not required
  - Seizure and sale of assets
  - Corporate forfeiture

# CONTESTING A DISAGREED AUDIT – NEW YORK

- Informal Protest – easiest and fastest way to challenge a bill or adjusted refund.
  - Online, phone, or mail
- Formal Protest
  - File Form CMS-1, *Request for Conciliation Conference* or
  - File Division of Tax Appeals Form TA-100, *Petition*
- Generally must file appeal within 90 days of the notice bill

# CONTESTING A DISAGREED AUDIT – CALIFORNIA

- Submit a protest online through MyFTB or a written protest can be file by the protest date on the front of the Notice of Proposed Assessment
- Protest Letter
  - Must clearly state what you are protesting and must be submitted online, mailed with a postmark date, or faxed by the protest by date
  - Must include:
    - Name/Address
    - Social/FEIN
    - Amount and years you are protesting
    - A statement of facts
    - Your explanation of why you believe CA's assessment is wrong
    - Evidence/documentation
    - Signature, phone number
    - Copy of the notice of proposed assessment
    - POA if needed
- Once decision is made, taxpayer will be sent a Notice of Action



# OFFSETTING A STATE TAX ASSESSMENT

# REVERSE AUDIT/LOOK-BACK REVIEW

- Applies to income/franchise and sales and use taxes
- Review same documents as an auditor
- Determine exposures or refund opportunities
- Exposure
  - Voluntary disclosure or tax amnesty, if applicable
- Refunds
  - File refund claims

# FINDING OVERPAYMENTS

- Auditors like to find underpayments and overlook overpayments
- Double check auditors' results and make sure overpayments, if any, are being applied against any assessment
- Need to review documents
  - Reverse audit



# WHERE ARE STATES LOOKING FOR MONEY

# CASTING THE BIG NET

- Budgetary deficits
  - Narrow the gap by:
    - Increasing the tax base
      - Tax more services – sales and use taxes
      - Cast a bigger net via nexus
      - Income/Franchise: Economic Nexus, combine reporting
      - Sales and use tax: Click-through and affiliate nexus
      - Income/franchise tax apportionment of services
      - Movement to “benefit” sourcing
- Nexus questionnaire
  - Bring in out of state companies



# CONCLUSION

# TAKE AWAY

- State agencies or departments (units) are sharing information
  - Example
    - Secretary of state and department of revenue
    - Withholding unit sharing information with income/franchise units
- States are sharing information with each other
- Audits have increased
  - Obtaining information via audits of other taxpayers
- Budgetary deficits
  - Narrow the gap by:
    - Increasing the tax base
      - Tax more services
      - Cast a bigger net via nexus



# QUESTIONS?



**Jeanna Schenk, CPA**

[Jeanna.schenk@redw.com](mailto:Jeanna.schenk@redw.com)



## **George W. Rendziperis, JD**

[George.rendziperis@redw.com](mailto:George.rendziperis@redw.com)

512.663.0132