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Past – Present – Future

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2017 CNY Manufacturing Conference

Crowne Plaza, Syracuse, NY

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Circular 230

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Topics to be Covered Today

Past

Everything you need to know about Audits

Present

2017 Tax Updates

State Nexus Issues

IC-DISC's

Future

The Future of Taxation & What it could look like

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- THE PAST -

Everything you Need to Know about Audits

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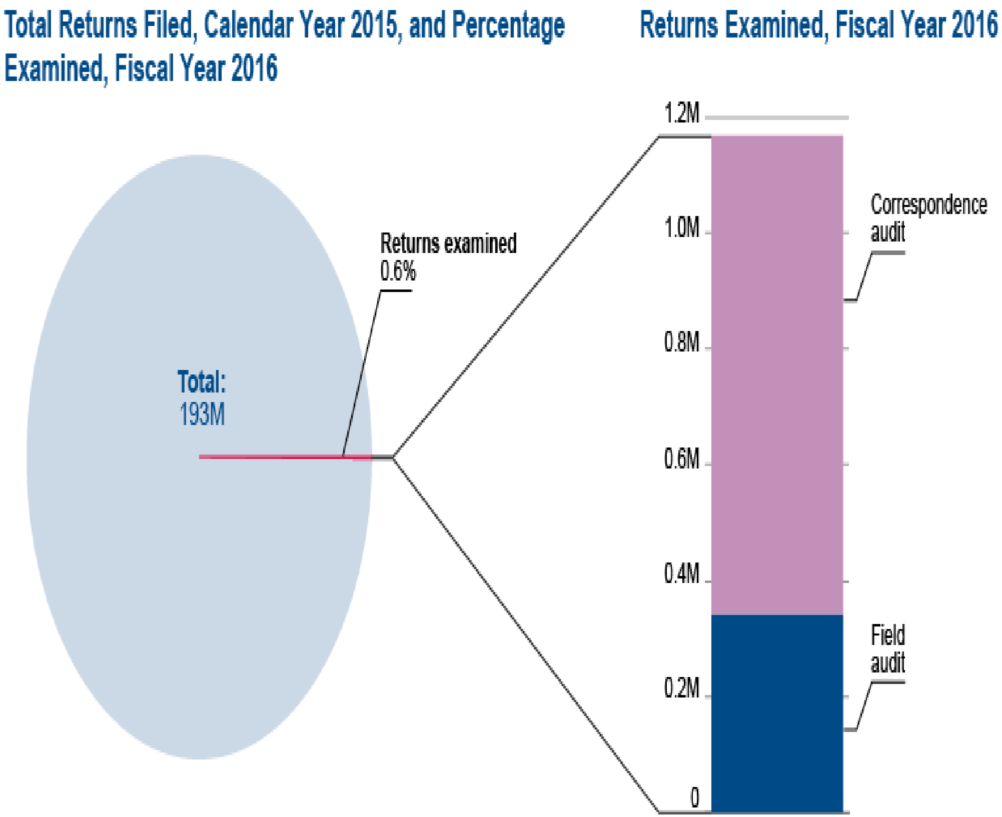
Introduction to IRS Audits

- Understanding how IRS Audits are selected and conducted can save your business time, money and future headaches.

- During the 2015 Calendar Year, there were 193M returns filed with the IRS. Approximately 10.5M of those returns filed were business returns (1120, 1120S and 1065).

- Of the 10.5M business returns filed, nearly 52K (0.49%) were audited.



SOURCE: 2016 *IRS Data Book* Table 9a

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Introduction to IRS Audits Continued...

What can the IRS audit?

- Corporate Income Tax Returns (Form 1120, 1120-C and 1120-F).
- Business Pass-Through Tax Returns (Forms 1120-S and 1065).
- Excise Tax Returns.
- Employment Taxes “Payroll Audits.”

How far back can the IRS go to audit my return?

Generally, the IRS will audit tax returns filed within the last three years. However, if they identify a substantial omission that exceeds 25% of gross income on a return, they may add additional years. They usually do not go back more than six years. The statute of limitations period for collection of taxes is generally ten years.

How long does it take the IRS to select a return for examination?

The IRS tries to audit tax returns as soon as possible after they are filed. Accordingly, most audits will be of returns filed within the last two years.

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Initial Correspondence From IRS

Notices/Letters

If you receive a notice/letter from the IRS, do not automatically assume that you are being audited. In reality, the majority of IRS correspondence sent to taxpayers is simply a request for more information. However, every notice/letter sent by the IRS contains valuable information which should be read carefully and understood fully before any response is made.

There are various reasons why the IRS would send a notice/letter. Here are just a few:

- There is an unpaid balance due with a return.
- There is a question regarding a return.
- Additional information is needed.
- There was a change made to a return.
- A return has been “selected for examination” (an audit may follow).

Phone Calls/Emails

The IRS will never contact you by phone or email without initially sending a notice or letter.

* Beware of phishing scams

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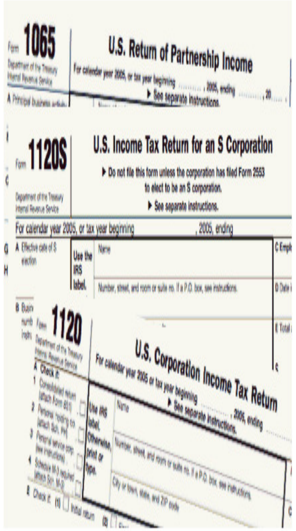
Why is my Return Being Selected for Examination?

Random Selection/Computer Screening

A portion of returns selected to be examined by the IRS each year are randomly selected on the basis of computer scoring. A computer program called the Discriminant Inventory Function System (DIF) assigns a numeric score to each individual, partnership and corporate return after they have been processed. The program is designed to compare your tax return against “norms” for similar returns. If your return is selected because of a high DIF score, it is more likely that an examination of your return will follow.



Automatic Under-reporter Program (AUR) & Information Matching

The IRS also selects returns for examination due to inconsistencies between third-party documentation previously filed with the IRS, such as W-2’s and 1099’s, and amounts on the taxpayers return.

Why is my Return Being Selected for Examination? Continued…

Related Examinations

Returns may also be selected for examination when they involve issues or transactions with other taxpayers, such as business partners or investors, whose returns were selected for an audit.

Third Party Information/Non-Compliance

Lastly, a return may be selected for examination when information is received by the IRS from other sources on potential non-compliance with the tax law or inaccurate filing. The information can come from a number of sources, including newspapers, public records and individuals. The information from these sources is evaluated for reliability and accuracy before it is used as the basis of an examination or investigation.

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What are the Different Examination Methods used once my Return has been Selected?

Four Examination Methods used by the IRS

If the IRS has questions, needs more information or wants to further examine your return, they will deploy one of the following examination methods:

- Proposed Adjustment for Underpaying or Overpaying your Taxes (CP-2000 Letter).
- Correspondence Audit (Form 566 (CG)).
- Office Audit (Form 3572).
- Field Audit (Letter 2205/Letter 3572).

The method of examination that the IRS chooses to deploy will depend on the amount of information that they are seeking to obtain and its severity. However, in all cases, the burden is on you to prove that you complied with the required statutory and regulatory laws set forth in the Internal Revenue Code!

Correspondence Audits

The most common type of audit (70.7% in 2016) that is deployed by the IRS and is the simplest to resolve.

Correspondence Audits involve the IRS mailing a letter to a taxpayer requesting more information about a particular item(s) on their tax return. In addition, to a request for more information, the IRS may also require you to fill out a questionnaire depending on the item(s) in question.

> Ex. The IRS has questions regarding a business deduction on your return and they request that you send in the proper source documentation to substantiate it (receipts, invoices, payments, etc.)

Tend to be simple requests; however, do not take these requests lightly. It is important that you still speak with your tax professional to ensure that you are providing the IRS with the correct documentation so that the audit can be quickly resolved.

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Office Audits

If the IRS has further questions about your return that extend beyond the normal correspondence letter, an Office Audit may be requested.

Office Audits require a taxpayer or a qualified representative of the taxpayer (Enrolled Agent, CPA, Attorney) to set-up an appointment with the IRS (either at home, office or at the local IRS office) to discuss items on your tax return that they have further questions about.

Office Audits require more time and attention than Correspondence Audits do, but are usually completed within one day.

Because the evidence required for you to prove your case in an Office Audit may be substantial, it is very important that you are fully prepared with the appropriate documents when it comes time to sit down with the auditor. We advise that you seek assistance from a CPA or Attorney prior to meeting with the IRS.

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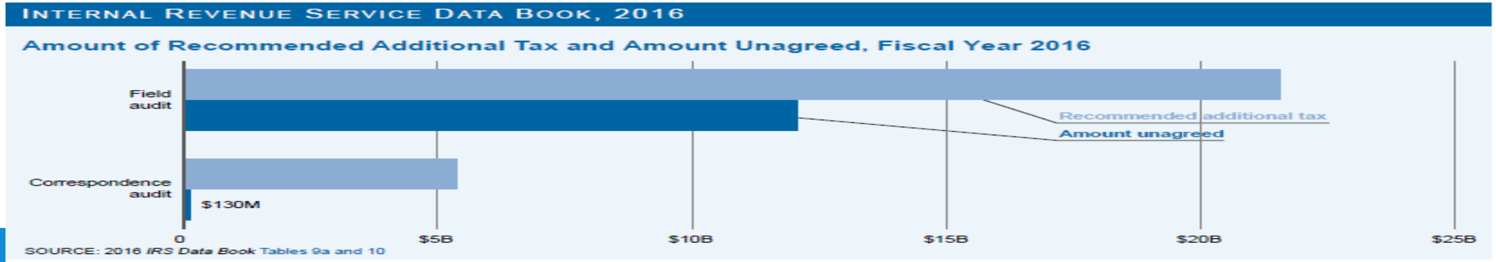
Field Audits

If the solution to an issue the IRS has with your return cannot be resolved by a letter or an office visit, the IRS may request that a Field Audit be completed. This type of audit is the least common, but the most serious and comprehensive style of examination the IRS can deploy. If a Field Audit is requested, it is likely the IRS suspects a violation may have occurred and they may propose adjustments to the return.

An IRS auditor will come to your place of business to review your accounting records. In this type of audit, the IRS can request to examine any forms, documents or previous years' tax returns (within certain limits) to ensure that all items are accurately stated.

In most cases, Field Audits require several visits from the IRS auditor and can vary in the time it takes to resolve. Thus, we strongly advise you to seek advice and guidance from a tax professional to answer questions on your behalf and to ensure fair processing.



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What types of Documents/Records Should you Keep?

All Audits are not created equal! Each one focuses on certain aspects of your return that may differ from others. Thus, the records that the IRS will request from you will depend on the circumstances of the audit. Generally, the following records should be kept for 3 years from the date you filed your return to 7 years if you claim a loss from worthless securities or a bad debt deduction:

- ***Gross Receipts*** — Cash Register Tapes / Deposit Info / Receipt Books / Invoices / Forms 1099-MISC
- ***Purchases*** — Canceled Checks / Other Documents that Identify Payee, Amount, Proof of Payment / Electronic Funds Transferred / Cash Register Tape Receipts / Credit Card Receipts / Invoices
- ***Expenses*** — Canceled Checks / Other Documents that Identify Payee, Amount, Proof of Payment / Electronic Fund Transferred / Cash Register Tape / Account Statements / Credit Card Receipts / Invoices
- ***Assets*** — Documents that show: When and How you Acquired the Assets / Purchase Price / Cost of any Improvements / How You Used the Asset / When and How you Disposed of Asset / Selling Price / Expenses of Sale
- ***Employment Taxes*** — Your Employment I.D. # / Amounts and Dates of all Wage, Annuity and Pension Payments / Dates of Employment / Forms W-4, W-4P, W-4S, W-4V / Dates and Amounts of Tax Deposits / Records of Fringe Benefits Provided

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What types of Documents/Records Should you Keep? Continued..

IF you have expenses for . .	THEN you must keep records that show details of the following elements . . .			
	Amount	Time	Place or Description	Business Purpose Business Relationship
Travel	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, fees and tips, etc.	Dates you left and returned for each trip and number of days spent on business.	Destination or area of your travel (name of city, town, or other designation).	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. Relationship: N/A
Entertainment	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Date of entertainment. (Also see *Business Purpose*.)	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see *Business Purpose*.)	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity. Relationship: Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.
Gifts	Cost of the gift.	Date of the gift.	Description of the gift.	
Transportation	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car.	Your business destination.	Purpose: Business purpose for the expense. Relationship: N/A

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What are my rights during an Audit?

It is vital that you know your rights as a taxpayer!

Just because you hire a tax professional does not mean you are guilty, it just means that you are taking the matter seriously!

The Taxpayer Bill of Rights

1. The Right to Be Informed

Taxpayers have the right to know what they need to do to comply with the tax laws. They are entitled to clear explanations of the laws and IRS procedures in all tax forms, instructions, publications, notices, and correspondence. They have the right to be informed of IRS decisions about their tax accounts and to receive clear explanations of the outcomes.

2. The Right to Quality Service

Taxpayers have the right to receive prompt, courteous, and professional assistance in their dealings with the IRS, to be spoken to in a way they can easily understand, to receive clear and easily understandable communications from the IRS, and to speak to a supervisor about inadequate service.

3. The Right to Pay No More than the Correct Amount of Tax

Taxpayers have the right to pay only the amount of tax legally due, including interest and penalties, and to have the IRS apply all tax payments properly.

4. The Right to Challenge the IRS's Position and Be Heard

Taxpayers have the right to raise objections and provide additional documentation in response to formal IRS actions or proposed actions, to expect that the IRS will consider their timely objections and documentation promptly and fairly, and to receive a response if the IRS does not agree with their position.

5. The Right to Appeal an IRS Decision in an Independent Forum

Taxpayers are entitled to a fair and impartial administrative appeal of most IRS decisions, including many penalties, and have the right to receive a written response regarding the Office of Appeals' decision. Taxpayers generally have the right to take their cases to court.

6. The Right to Finality

Taxpayers have the right to know the maximum amount of time they have to challenge the IRS's position as well as the maximum amount of time the IRS has to audit a particular tax year or collect a tax debt. Taxpayers have the right to know when the IRS has finished an audit.

7. The Right to Privacy

Taxpayers have the right to expect that any IRS inquiry, examination, or enforcement action will comply with the law and be no more intrusive than necessary, and will respect all due process rights, including search and seizure protections and will provide, where applicable, a collection due process hearing.

8. The Right to Confidentiality

Taxpayers have the right to expect that any information they provide to the IRS will not be disclosed unless authorized by the taxpayer or by law. Taxpayers have the right to expect appropriate action will be taken against employees, return preparers, and others who wrongfully use or disclose taxpayer return information.

9. The Right to Retain Representation

Taxpayers have the right to retain an authorized representative of their choice to represent them in their dealings with the IRS. Taxpayers have the right to seek assistance from a Low Income Taxpayer Clinic if they cannot afford representation.

10. The Right to a Fair and Just Tax System

Taxpayers have the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely. Taxpayers have the right to receive assistance from the Taxpayer Advocate Service if they are experiencing financial difficulty or if the IRS has not resolved their tax issues properly and timely through its normal channels.

Tax Planning Tips to Help Mitigate your Risk of Being Audited?

Pay Attention to Key Items that Tend to Trigger Red Flags

There are certain items on tax returns that increase your company's chances of getting audited that you should be aware of to ensure that they are properly stated in accordance with the Internal Revenue Code. Four of the most scrutinized items that may trigger an IRS Audit are:

Owners Compensation

The IRS heavily scrutinizes owners compensation due to the effect it has on the amount of tax due and its effect on payroll taxes. For example, a privately held C-Corp. may try to overpay its owners in lieu of paying dividends to avoid double taxation. Conversely, an S-Corp. may try to underpay its owners to minimize payroll taxes and, instead, make higher distributions. The IRS pays close attention to how much businesses compensate their owners and will compare your business's owners compensation to that of other manufacturers or distributors in your area.

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Tax Planning Tips to Help Mitigate your Risk of Being Audited? Continued…

Travel Expenses

Business owners may push the envelope when it comes to deducting business and travel expenses. I.R.C § 162 states that costs for transportation, lodging and meals are generally deductible if the expenses are reasonable and necessary, and if the trip is primarily for business. Costs that are personal in nature or deemed to be lavish/extravagant under the circumstances are not deductible. In addition, it is important to remember that you will need to provide more than just a credit card statement when justifying your travel expenses to the IRS, especially if your family accompanies you on the trip or you extend the trip for personal reasons. Even if an expense is clearly deductible, the deduction can be denied if not substantiated. Taxpayers must keep adequate records and documentary evidence. However, the taxpayer can use the per diem method of deducting expenses and still satisfy the substantiation requirements for the amount of the expense. The time, place and business purpose must still be substantiated through adequate records and documentary evidence.

Tax Planning Tips to Help Mitigate your Risk of Being Audited? Continued…

Meals & Entertainment

The IRS can compare your M&E deductions to those of other manufacturers and distributors in your area as well. Thus, deducting excessive M&E expenditures may set-off a red flag with the IRS. I.R.C. § 274(n) states that any expense related to a taxpayers trade or business for food or beverages and any items with respect to an activity which is a type generally considered to constitute entertainment, amusement or recreation, or with respect to a facility used in connection with such activity shall be allowed a 50% deduction if it is incurred directly for use by a client, customer or employee.

Keeping records is the key to protecting your M&E deductions. We advise that your company's expense reimbursement forms include the following information to prove that your M&E deductions are all qualified:

- Amount of expense;
- Time and place;
- Business purpose; and
- Name and business relationship of any person entertained.

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- THE PRESENT -

Federal Tax Updates

Navigating State Nexus Laws

Interest Charge Domestic International Sales Corporations

Federal Tax Updates

Update on Important Tax Items

- **Research & Development (R&D) Tax Credits**
- **Section 179 Expensing Election and Bonus Depreciation**
- **The Domestic Production Activity Deduction**

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Federal R&D Credit

- Under the ***Protecting Americans From Tax Hikes Act of 2015 (“PATH”)***, the credit was made permanent.

- The PATH Act also includes a provision whereby certain eligible small businesses (defined as those with average gross receipts of under $50 million for the previous three tax years), can use the Federal R&D credit to not only offset regular tax, but also the alternative minimum tax. Prior to the PATH Act, the Federal R&D credit could not be used to offset alternative minimum tax.

Federal R&D Credit
Qualified Research Expenses

Qualified Research Expenses (QREs) are defined by Section 41(b) of the Internal Revenue Code and include the following:

- Wages paid or incurred to an employee for “qualified services” performed by the employee.
- Any amount paid or incurred for supplies used in the conduct of qualified research.
- Any amount paid or incurred for the right to use computers in the conduct of qualified research.
- 65% of any “contract research expenses” paid or incurred to any person (other than an employee) for the conduct of qualified research.

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Federal R&D Credit
Qualified Research

In order for an activity to constitute "qualified research" it must meet four criteria:

1. <u>The Section 174 Test</u>: The activity must qualify as research pursuant to Internal Revenue Code Section 174 which requires that an activity be research in the "experimental or laboratory sense aimed at the development of a new product."
2. <u>The Business Component Test</u>: The information sought must be intended to be useful in the development of a new or improved business component of the taxpayer.
3. <u>The Technical Discovery Test</u>: The research has to be undertaken for the purpose of discovering information that is technological in nature.
4. <u>Process of Experimentation</u>: To constitute qualified research, substantially all of the activities must be part of a process of experimentation that relates to a qualified purpose.

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Section 179 Expensing Election

- Pursuant to IRC Section 179, manufacturers are allowed to expense the cost of qualifying fixed asset purchases up to a statutory limit (the **“**dollar limitation**”**) provided certain requirements are met.

- The ***Protecting Americans from Tax Hikes Act of 2015*** (“PATH”) permanently extended the dollar limitation back to its previous level of $500,000 for up to $2 million of qualified additions for 2015 (the “investment limitation”). **New for 2017, the dollar limitation has increased to $510,000 for up to $2,030,000 of qualified additions**.

- Qualifying additions exceeding the $2,030,000 investment limitation reduce the eligible Section 179 deduction dollar-for-dollar (i.e. the deduction is completely phased-out for qualifying investments that exceed $2.54 million).

Section 179 Expensing Election

Tax Tip

- It is advisable to maximize the first year Section 179 deduction on longer-lived assets first and then apply any remainder to shorter-lived assets.

Section 179 Expensing Election

Section 179 – Example #1

2016 Capital Expenditures

Asset	Depreciable Life	Cost
Computer Software	3 Years	$50,000
Computer / Network Equipment	5 Years	100,000
Manufacturing Equipment	7 Years	1,700,000
Qualified Retail Improvements	15 Years	300,000
		$2,150,000

As shown, ABC's qualifying additions exceeds the investment limitation of $2,030,000; therefore, the dollar limitation is reduced dollar-for-dollar resulting in a maximum allowable Section 179 deduction of $390,000.

2016 Section 179 Election

Asset	Cost	Section 179
Computer Software	$ 50,000	$ -
Computer / Network Equipment	100,000	-
Manufacturing Equipment	1,700,000	140,000
Qualified Retail Improvements	300,000	250,000
	$ 2,150,000	$ 390,000

In allocating the Section 179 deduction of $390,000, it is more advantageous to utilize the deduction against the longer-lived assets first; therefore, $250,000 is allocated to the QRIs and the balance against the manufacturing equipment.

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Section 179 Expensing Election

- Aside from the dollar limitation and the investment limitation, there is a taxable income limitation that must be met.
- For C-Corporations, this means that the Section 179 deduction cannot reduce taxable income below $0 in a given tax year (without regard to NOL carrybacks or carryforwards).
- Similar rules for S-Corporations, partnerships, LLCs and LLPs also exist with one important distinction which is often overlooked.

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Section 179 Expensing Election

Tax Tip

- For S-Corporations, taxable income for purposes of the Section 179 limitation is computed without regard to compensation paid to an S-Corporation's shareholder employees (Regulation Section 1.179-3).
- In similar fashion, taxable income for partnerships, LLCs and LLPs is computed without regard to guaranteed payments paid to partners or members (Reg. Sec. 1.179-2).

Section 179 Expensing Election

- Any excess Section 179 expense that exceeds the taxable income limitation can be carried forward indefinitely and utilized to the extent of the taxable income limitation.
- Members of a related group of corporations connected through common stock ownership (a "controlled group of corporations") are treated as one taxpayer for purposes of the Section 179 deduction and, therefore, are allowed one $510,000 deduction.

Section 179 Expensing Election

- As illustrated in the preceding examples, only certain types of property qualify for Section 179 expensing, including tangible personal property, off-the-shelf software, qualified leasehold improvements, and qualified retail improvement costs.
- Real property, including buildings and structural components do not qualify; however, a cost segregation study may be used to reclassify building costs to a different category.

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Bonus Depreciation

- In addition to the Section 179 expensing election, the *2015 PATH Act* also extended the Section 168(k) “bonus depreciation” rules through the tax year ending on or before December 31, 2019.

- Manufacturers may write-off the first 50% of qualifying additions placed in service in 2017, <u>without limitation</u>. As part of the *2015 PATH Act,* in 2018 the applicable write-off percentage decreases to 40% of qualifying additions, and in 2019 the applicable write-off percentage further decreases to 30% for qualifying additions before being completely eliminated for tax years beginning January 1, 2020 and later.

Bonus Depreciation

- However, unlike the Section 179 deduction, the property must be new in that the original use of the asset must commence with the taxpayer and cannot be used property.
- Qualifying property must have a class life of 20 years or less and can include capitalized reconditioning costs.
- Similar to the Section 179 deduction, bonus depreciation is also allowable for Alternative Minimum Tax (AMT).

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Bonus Depreciation

Tax Tip

- Section 179 election is generally preferred over 50% bonus depreciation since it produces a greater tax deduction in the year of acquisition assuming limitations are met.
- However, the 50% bonus depreciation deduction does <u>not</u> have a taxable income limitation which means it can be used to create a tax loss in a given year, regardless of the form of entity.

Bonus Depreciation

Tax Tip (con't.)

- One drawback of the 50% bonus depreciation deduction is that most states (including New York) have "decoupled" from this Federal tax law and manufacturers utilizing this deduction will be required to make certain adjustments at the state level in computing their state tax liabilities; this includes shareholders in S-Corporations, partners in partnerships and members of LLCs or LLPs.

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Bonus Depreciation

Example #2

- Consider the same facts as Example #1, after considering bonus depreciation and regular first year depreciation (MACRS), ABC Company, Inc.'s total first year depreciation is, as follows:

Asset	Cost	Section 179	Bonus Depreciation	MACRS	MACRS w/o Section 179 and Bonus Depreciation
Computer Software	$ 50,000	$ -	$ 25,000	$ 4,167	$ 8,334
Computer / Network Equipment	100,000	-	50,000	10,000	20,000
Manufacturing Equipment	1,700,000	140,000	780,000	111,462	242,930
Qualified Leasehold Improvements	300,000	250,000	25,000	1,250	15,000
	$ 2,150,000	$ 390,000	$ 880,000	$ 126,879	$ 286,264

Total First Year Depreciation w/179 and 50% Bonus	**$ 1,396,879**
Total First Year Depreciation w/o 179 and 50% Bonus	**286,264**
Additional First Year Depreciation Deductions	**$ 1,110,615**

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The Qualified Production Activity Deduction for Manufacturing / Production Activities

Overview of Section 199

- The Code permits a deduction against a certain class of net income – qualified production activity income (“QPAI”).
- The deduction equals 9% of the lesser of QPAI or, in the case of a C corporation, modified taxable income or, in the case of an individual, modified adjusted gross income.

The Qualified Production Activity Deduction for Manufacturing / Production Activities Continued…

There is a “cap” on the deduction equal to 50% of W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year.

The domestic production activities deduction is allowed for AMT.

Available to C corporations, S corporations, partnerships, sole proprietorships, estates and trusts.

The Qualified Production Activity Deduction for Manufacturing / Production Activities Continued…

The Calculation of the Qualified Production Activity Deduction.

- The first calculation is qualified production activity income.
  - QPAI is defined as the excess of the taxpayer's domestic production gross receipts (DPGR) over the sum of:
    - The cost of goods sold;
    - Other deductions, expenses and losses directly allocable to such receipts; and
    - A ratable portion of deductions, expenses and losses not directly allocable to such receipts or another class of income.

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The Qualified Production Activity Deduction for Manufacturing / Production Activities Continued…

- In general, Section 199 defines DPGR as gross receipts of the taxpayer derived from the following sources:
  - Any lease, rental, license, sale, exchange, or other disposition of:
    - Qualifying production property (tangible personal property, any computer software, and certain sound recordings) which was manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States;

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The Qualified Production Activity Deduction for Manufacturing / Production Activities Continued…

  - Any qualifying film produced by the taxpayer; and
  - Electricity, natural gas, or potable water produced by the taxpayer in the United States.
- Construction performed in the United States.
- Engineering or architectural services performed in the United States for construction projects in the United States.

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Navigating State Nexus Laws

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States and Local Jurisdictions have Several Problems

- Budget Deficits.
- Lack of taxpayer conformity with sales/use tax reporting.
- Inability to identify non-resident business entities.
- Their problem is now YOUR problem.

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Revenue Sources for States

- Sales/Use Tax – 31.4%
- Individual Income Tax – 37.3%
- Corporate Taxes – 5.0%
- Other Taxes – 26.3%

What is Nexus?

Nexus in general means a connection.

- For tax purposes, it is a legal term that describes the amount and degree of business activity that must be present before a state can tax an entity's income or for taxes on sales within the state.

- If a taxpayer has nexus in a particular state, the taxpayer is required to pay and collect/remit sales taxes in that state and pay income tax on income generated in that state.

Sales & Use Tax

Current Trends

- 2016 U.S. Census Bureau data statistics state that $395 billion of revenue comes from retail e-commerce sales.
- In 2016 alone, it is estimated that states lost out on $26 billion of revenue due to the inability to collect sales taxes from online and catalog sales.

Understanding Sales & Use Tax Nexus

- Federal law requires a state to have “substantial nexus” to a seller before it can require that seller to collect sales & use tax. However, the definition of “substantial nexus” has always been a subject of contentious debate between states and businesses.
- Generally, however, “substantial nexus” means having a “presence” or performing “sufficient activity” in the state, whether that be by salesperson, contractor, location or a number of different events.

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What is Economic Nexus?

- Due to the huge shift in online commerce states have began to make adjustments to what they consider a presence in their state.
- States like New York, Alabama, Indiana, Massachusetts and several others have began to implement “economic nexus” standards or nexus for those taxpayers who are making sales into their state but lack physical presence.
- Ohio for example has adopted the “factor presence test” for purposes of determining what entities are subject to the Commercial Activity Tax (CAT). If an entity has sales into Ohio of at least $500K they are subject to the CAT tax.

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Amazon / Click-Through Nexus

Originated in New York: Law enacted on April 23, 2008, that requires out-of-state sellers to collect sales tax if they enter into an agreement with a New York resident for website referrals/links and pay a commission based on sales generated there.

- Presumption – A seller that makes taxable sales in a state that has nexus when a states resident's website clicks through potential customers to the seller.
- Rationale – Link on the website in New York creates a physical presence for the seller when the owner of the website is a resident of New York and acts as a "sales agent" for the seller.

Corporate Income Tax Nexus

- The state in which a business is incorporated has the jurisdiction to tax the corporation, regardless of the amount of business activity that is conducted within the state.

- Whether a state has the right to tax the income of a business that is incorporated in another state depends on the connection between the state and the corporation.

- "Nexus" is the term that is used to describe the degree of business activity that must be present before a taxing jurisdiction has the right to impose a tax on a corporation's income.

Corporate Income Tax Nexus Continued…

- In addition, an activity is immune from taxation if it consists merely of solicitation; since "solicitation" is not defined by P.L. 86-272, each state felt free to select its own interpretation.
- For example, the State of Connecticut declares that the following activities constitute carrying business:
    - Owning real property;
    - Leasing real property as lessee;
    - Maintaining an office;
    - Compensating an employee for use of his or her house as an office;

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Corporate Income Tax Nexus Continued…

- Selling tangible personal property, as opposed to solicitation of orders;
- Performing or soliciting orders for services;
- Selling or soliciting orders for real property;
- Maintaining inventory in a public warehouse;
- Delivering merchandise inventory on consignment to distributors or dealers;
- Owning or leasing (as lessee) personal property not related to solicitation of orders; and
- Participating in the approval of distributors or dealers who will service and repair products for customers and users.

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Corporate Income Tax Nexus Continued…

- In addition to the activities above, a corporation will be treated as carrying on business in Connecticut if its employees do any of the following actions in the state, even if the employee is based elsewhere:
  - Engages in managerial or research activities;
  - Collects on regular or delinquent accounts;
  - Offers technical assistance or training to customers or users after the sale;
  - Repairs or replaces faulty products;

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Corporate Income Tax Nexus Continued…

- Installs or assembles products;
- Visits customers or users to determine product satisfaction;
- Picks up returned merchandise from customers or users;
- Solves or attempts to solve product, credit, shipping or similar complaints;
- Verifies destruction of damaged merchandise;
- Coordinates deliveries, whether or not there are any special promotions;
- Distributes replacement parts;
- Inspects product installations made by customers or users; and
- Conducts credit investigations or arranges for financing.

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Examples of “Nexus” Pitfalls

Using sales people and independent representatives to sell products.

- A manufacturer in the Midwest used both company sales people and independent representatives to sell its product to retail and end users. A western state determined this manufacturer’s activities in its state created sales tax nexus. The manufacturer was assessed sales tax, penalty and interest for a 10 year period.

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Examples of “Nexus” Pitfalls

Shipping products on consignments to customers.

- A manufacturer shipped its product on consignment to its largest customers location in multiple states. A state determined that this activity in their state created income tax and sales tax nexus. The manufacturer was assessed tax, penalty and interest for a 5-year period. This information was shared by the assessing state with the other states that also assessed the manufacturer.

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Examples of "Nexus" Pitfalls Continued…

Selling to customers in several states.

- A manufacturer of specialized equipment sold products to customers in several states. These sales generally included a factory representative who would install and help set-up the equipment. An audit conducted on the out-of-state customer led to an audit of the manufacturer. It determined that the manufacturer had sales tax and income tax nexus with its state. The audit resulted in tax assessment, penalty and interest. This state also shared the information with several other states that also assessed tax.

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Interest Charge Domestic International Sales Corporation (IC-DISC)

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Manufacturing and IC-DISC's

What is an IC-DISC?

- An IC-DISC is a tax-exempt corporation (pays no Federal income tax), which generates commission income from a "related producer," or the manufacturing entity.
- The IC-DISC generates commission income from the related producer's sale of "qualified export property," which is deductible to the related manufacturer.

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Manufacturing and IC-DISC's Continued…

Transactions with the IC-DISC

- The IC-DISC generates commission income from the related manufacturer on qualified export sales equal to the greater of:
  - 50% of the net profit on the export sales; or
  - 4% of the total export sales (limited to net profit).
- The IC-DISC generates commission income, while the related producer deducts the commission expense, reducing taxable income of the manufacturer.

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Manufacturing and IC-DISC's Continued…

Benefits of the IC-DISC

- The related manufacturer is able to deduct commission payments against taxable income:
  - Up to 35% for C-Corporations; and
  - Up to 39.6% for pass-through entities (S-Corp / Partnership).
- The IC-DISC pays no Federal income tax on the commission income (no state tax in New York) on undistributed profits.

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Manufacturing and IC-DISC's Continued…

Benefits of the IC-DISC (continued)

- The commission income is not taxed until a taxable dividend is paid from the IC-DISC to its shareholders.
    - Taxed at "qualified dividend" rates (15-20%), and subject to net investment income tax rules (3.8%).
- IC-DISC can defer tax on up to $10 million in export gross receipts per year, and deferral is indefinite (until dividends are paid to its shareholders).

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Manufacturing and IC-DISC's Continued…

<u>Benefits of the IC-DISC (continued)</u>

- Undistributed profits are subject to an annual interest charge on the amount of income tax deferred.
  - 2016 interest rate was 0.54%.
  - In 2016, the cost to defer $100,000 in tax on undistributed profits was $540 (0.54% of $100,000).
- There are additional planning opportunities available for the manufacturing entity to make use of the undistributed profits of the IC-DISC, without incurring a tax liability.

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- THE FUTURE -

What the Future of Taxation Could Look Like

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Tax Reform Talking Points

- Lower tax rates for individuals and families.
- Lower tax rates for corporations.
- Lower tax rates for income earned by pass-through businesses and small businesses.
- Accelerated cost recovery or unprecedented expensing.
- Repatriation of trapped profits overseas.

"Unified Framework" for Tax Reform

- Released September 2017.
- Joint effort by the White House, Republican leaders of the U.S. House & Senate and Chairs of the House & Senate Tax Writing Committees.
- Similar to House Republicans A Better Way "Blueprint."

"Unified Framework" Continued…

What it proposes:

- Shrinks individual tax brackets from 7 to 3 – 12%- 25% - 35% with the potential for an additional top rate for the highest-income taxpayers.
- Doubles the standard deduction and increases the Child Tax Credit.
- Repeals AMT.
- Lower tax rate and structure for small businesses – limits maximum tax rate for small and family-owned businesses to 25%.

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“Unified Framework” Continued…

- Corporate tax rate is reduced to 20% and 100% exemption for dividends from foreign subs in which the U.S. parent owns at least a 10% stake.
- 5 years of immediate expensing of new investments.
- One-time, low tax rate on overseas profits.
- Eliminates the Section 199 “Domestic Production Activity Deduction.”
- Preserves the R&D Credit.
- Ensures manufacturers lowest marginal rates in almost 80 years!

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Important to Remember

- Proposals only provide general details regarding the proposed changes.
- Tax code is very complex and changes are not easily made.
- No proposals have been signed into law.
- Make yourself aware of the proposals and speak with a tax professional to ensure proper planning.

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Questions

Appendix

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What Happens When you Agree with the Audit Findings?

If you agree with an auditors findings, you will be asked to sign an examination report or a similar form depending upon the type of audit conducted. You must pay interest & any additional tax. If you think you will owe additional tax before the end of an examination, you can stop the further accrual of interest by sending money to the IRS to cover all or part of the amount you think you will owe.

If there is an amount due for any additional tax that you may owe, you should pay that amount as soon as possible.

Paying with Agreement

If you pay when you sign the agreement, the interest is generally figured from the due date of your return (excluding extension of time to file) to the date of your payment.

Deferral of Payment to Later Date

If you do not pay the additional tax when you sign the agreement, you will receive a bill that includes interest. If you pay the amount due within 10 business days of the billing date, you will not have to pay more interest or penalties.

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What Happens When you Disagree with the Audit Findings?

Upon conclusion of an audit if you do not agree with an auditors proposed changes to your return, you have the right to make an appeal.

Office Audits

If your examination takes place in an IRS office, you can request an immediate meeting with the examiner's supervisor to explain your position.

Non-Office Audits

If your examination does not take place in an IRS office, the examiner will write up your case explaining your position and the IRS's position.

Local Appeals Office

Separate & independent office from the IRS office. This is the only level of appeal within the IRS. Conferences with Appeals Office personnel are held in an informal manner by correspondence, by telephone, or at a personal conference. Most differences are settled at this level.

Appeals to the Courts

If there is still disagreement after the appeals conference, you may be entitled to take your case to the United States Tax Court, the United States Court of Federal Claims, or a United States District Court. All of which are independent of the IRS.

Are there Penalties and Interest Associated with Audits?

If you owe additional tax you will be subject to penalties & interest.

Tax Penalties

I.R.C § 6651(a)(2) states that a taxpayer who fails to pay the amount shown on their return unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return 0.5% of the amount of such tax if the failure is for not more than one month, with an additional 0.5% for each additional month or fraction thereof during which such failure continues, not exceeding 25% in the aggregate.

Interest

Accrues on the unpaid balance & compounds daily from the due date of the return (without regard to any extension of time to file) until you pay the balance in full.

- The Interest Rate is the Federal Short-Term Rate Plus 3%.
- The Federal Short-Term Rate is Determined Every Three Months.

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Other Taxpayer Audit Penalties

Taxpayer Audit Penalties

Exclusive of foreign reporting penalties

IRC Section	Violation	Description
6662	Accuracy-related penalty for negligence or disregard of rules and regulations, substantial understatement of tax, and substantial valuation misstatements	20% of understatement of tax, 40% of gross valuation misstatement
6662A	Accuracy-related penalty for reportable transactions	20% of the reportable transaction misstatement, 30% if not adequately disclosed on form 8886
6663	Underpayment resulting from fraud	75% of the underpayment resulting from fraud
6675	Erroneous refund claims	20% of the refund, reduced for other penalties
7201	Will attempt in any manner to evade or defeat tax	Felony up to $100,000 fine or five years in prison or both
7206	Willful making and subscribing to false statements; fraudulent understatement.	Felony up to $100,000 fine or five years in prison or both

www.irsmedic.com

Can Penalties and Interest be Suspended?

If you file a return timely (including extensions), interest & certain penalties will be suspended if the IRS does not mail a notice to you, stating your liability and the basis for that liability, within a 36-month period beginning on the later of:

- The date on which you filed your tax return; or
- The due date (without extensions) of your tax return.

The suspension period begins the day after the close of the 36-month period and ends 21 days after the IRS mails a notice to you stating your liability and the basis for that liability.

The suspension period does not apply to:

- Failure-To-Pay Penalty;
- Fraudulent Tax Returns;
- Penalty, Interest, Addition to Tax, or Additional Amount with Respect to any Tax Liability Shown on Your Return or With Respect to Any Gross Misstatement;
- Penalty, Interest, Addition to Tax, or Additional Amount with Respect to any Reportable Transaction that is not Adequately Disclosed or Any Listed Transaction; or
- Criminal Penalty.

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How do NYS Audits Compare to IRS Audits?

- Similar Process to IRS Audits.
- NYS Department of Taxation & Finance will first select an Audit Case based on the information available to them. Some reasons why they might select a return to be audited include:
  - Failure to file a return;
  - Failure to report income or sales;
  - Excessive credits or exclusions claimed on a return;
  - Incorrect or fraudulent refund claims or returns filed;
  - Differences found between a return that is filed and information obtained from third parties; and
  - Misuse of exemption certificates.
- Selection is made → Letter/Notice sent out or less frequently an appointment is set-up.
- As with the IRS, NYS requires that taxpayers:
  - Maintain records to support their return(s); and
  - Provide these records if requested.

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NYS Audits Continued…

Once the requested info has been sent back to NYS to verify that the return is accurate, a NYS Auditor will review the information and advise the taxpayer of their findings. The findings could be that there is no change, a refund due, or balance due.

If Taxpayer Agrees with Findings

The department will ask you to sign a Statement of Proposed Audit Changes (or similar document). If you owe additional amounts and you don't pay in full, NYS will send you a bill. If you can't pay in full, they will usually try to work out an agreement for you to pay in installments. However, interest and/or penalties may continue to accrue.

If Taxpayer Disagrees with Findings

Indicate your disagreement on the Statement of Proposed Audit Changes (or similar document) and return it to the address shown on the document. An auditor will review any additional information submitted and, if appropriate, send you a revised document. If you still don't agree, they will send you a Notice of Determination/Notice of Deficiency for the taxes due. At this point, taxpayers may formally appeal the audit findings through either the Tax Department Bureau of Conciliation and Mediation Services or through the independent Division of Tax Appeals.

Who and What Determines Nexus?

A number of Supreme Court Cases over the past half century have shaped what can be considered nexus generating activities.

Nexus is determined differently for income taxes and sales tax purposes.

Each state has its own rules for determining nexus that may slightly differ from the others.

A business will always have nexus in its home state.

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Issue for the Seller

- If it is deemed that an entity has sales & use tax nexus, then they could be liable for sales tax with little hope to recover from in-state customers.
- Compliance with nexus standards has always been a huge problem.
- Penalties and interest are seldom waived.

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Commerce Clause – Supreme Court Cases

- National Bellas Hess (1967) – requirement for some physical contact with the state & that state violated U.S. Constitution's Commerce Clause.
- Complete Auto Transit (1974) – created 4 part test to determine if state taxes discriminate or unfairly burden interstate commerce.
- Quill Corporation (1992) - Supreme Court ruled that attempts to impose use tax on goods purchased from an out-of-state mail order seller without outlets or sales representatives violated the Commerce Clause.

The tax must:

- Be related to an activity with substantial nexus;
- Be fairly apportioned;
- Not discriminate against interstate commerce; and
- Be fairly related to the services provided by the State.

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The Effects of Quill

- Set Standard for Sales Tax Nexus - applicable to all states.
- Established “substantial nexus” importance, but failed to define it.
- Established de minimus argument.
- States begin to define “substantial nexus” themselves:
  - Virtually any physical presence; or
  - In state activity must be “regular, continuous, and meaningful” – differs by jurisdiction.

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Physical Presence and Nexus

- Some states require out-of-state sellers to register for sales & use tax even if they only have one sale.
- Some states allow a temporary license or registration.
- Physical Presence may be determined on sales volume.

What is Attributional Nexus?

In an attempt to even further broaden the definition of nexus, many states have begun to assert nexus on businesses that simply have a relationship or affiliation with another entity doing business in the state.

When an out-of-state seller has a relationship with an in-state entity, it will sometimes create attributional nexus, or in other words nexus-causing activities of the in-state seller are attributed to the out-of-state seller on the basis of their relationship triggering nexus for the out-of-state entity.

States also assert that nexus exists based on the existence of common ownership between an in-state taxpayer & an out-of-state entity.

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Affiliate Nexus or “Click Through Nexus”

Even if you do not have a physical presence in a state your affiliates can create nexus for you.

If your company does not have a physical presence of its own in a state (such as having employees or maintaining inventory or other property), the company can still be subject to tax because of the in-state actions of their affiliate in the state. States are arguing that businesses should not be able to avoid taxation in their state simply by using an affiliate to physically conduct its in-state business.

Ex. If you are a retailer operating in a state & are working with an affiliate in another state that posts your links on their website you may have created affiliate nexus in that state and would then be required to collect and remit sales tax.

Sales Tax in the Cloud

Generally, sales tax is imposed on all sales of tangible personal property and specifically enumerated services.

Services – Taxation of services various by state.

Digital goods – What is it?

- Tangible personal property;
- Data processing;
- Information services;
- Telecommunications/ancillary;
- Services; and
- Software.

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Sales Tax in the Cloud Continued…

If taxable, to which state should the transaction be sourced for sales tax purposes?

- No delivery, so no destination state?
- If sourcing is based on use, which is the state of use?
    - Location of customer/user.
    - Location of the software/server.
    - Conflict with sourcing between states that source SaaS sales based upon location of customer vs. location of server.

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Sales Tax in the Cloud Continued…

If sourced by use and location of customer:

- How do we determine where user is and use by customer occurs?

- Factors:

  - Location of the server: What if multiple servers are involved?
  - Seller location: Where application is developed and maintained?
  - Customer billing address
  - User location: Allocation of contracts/licenses for users in multiple locations?

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Corporate Income Tax Nexus Continued…

The amount of activity to create a nexus is defined by each state.

1. If an entity derives income from sources within the state;
2. If an entity owns or leases property within the states;
3. If an entity employs personnel in the state in activities that exceed mere solicitation; or
4. If an entity has physical or financial capital in the state.

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Corporate Income Tax Nexus Continued…

In 1959, Congress enacted Public Law 86-272, to limit the states' rights to impose an income tax on interstate activities (codified as 15 USC 381).

1. This law prohibits a state from taxing a business whose only connection with the state is the solicitation of orders for sales of tangible personal property that are:
   - Sent outside the state for approval or rejection; and, if approved; or
   - Filled and shipped from outside of the state.

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Corporate Income Tax Nexus Continued…

2. Applies only to “net income” not based on something other than net income.
3. Note, this immunity does not extend to:
   - Selling or providing services;
   - Leasing or renting personal property; or
   - Any activity in connection with:
     - Real property; or
     - Intangibles.

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Corporate Income Tax Nexus Continued…

- Economic Nexus – Under previous law, a corporation does not have nexus if it only has sales into New York since nexus requires a physical presence, employees or assets in New York.
- The law adopts a "bright line" economic standard of taxation for corporations deriving at least $1 million of receipts from activities in New York beginning January 1, 2015.

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Corporate Income Tax Nexus Continued…

- For example, if an out-of-state company with no physical presence in New York has sales to New York customers in excess of $1 million, they will be subject to New York tax.
- Public Law 86-272 still applies and should provide a safe-harbor, but only for tax on income from sales of tangible personal property.
- Public Law 86-272 cannot protect against tax on capital or the fixed dollar minimum tax.

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The Wrigley Decision

- The term “solicitation” was finally defined, more than 30 years after the enactment of P.L. 86-272.

- On June 19, 1992, the U.S. Supreme Court reversed the decision of the Wisconsin Supreme Court in Wisconsin Department of Revenue vs. William Wrigley, Jr., Co.

- Wrigley conducted its worldwide chewing gum business from its Chicago offices and sold its products in Wisconsin through a sales force, consisting of a regional manager and several field representatives who resided in Wisconsin.

The Wrigley Decision Continued…

- As mandated by P.L. 86-272, all orders were sent to Chicago for acceptance or rejection, and were filled by common carrier shipments from outside of Wisconsin. In addition, no property was owned or leased by Wrigley in Wisconsin and all credit and collection activities (with a few exceptions) were handled from Chicago. Furthermore, all Wisconsin advertising was placed from out-of-state locations by a Chicago advertising agency.
- The regional manager had no office, and spent the majority of his time working with the field representatives (reps) and contacting key accounts. The reps were provided with company cars and were supplied with a stock of gum, company literature and display racks, which were supposed to be stored at their own homes. Typically, a rep would visit retail accounts, and would:
  - Distribute literature;
  - Provide free samples;
  - Replace stale gum with fresh gum (at no cost); and
  - Supply gum to accounts that had insufficient amounts on hand to fill display cases.

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Independent Contractors

- Public Law 86-272 extends immunity to certain in-state activities conducted by independent contractors that would not be permitted if performed directly by the business through its employees or manufacturer's representatives

  P.L. 86-272 accepts certain activities of "independent contractors"

  1. Typically, an independent contractor may engage in limited activities on behalf of a corporation without creating nexus for the business, such as:
     a) Soliciting sales;
     b) Making sales (accepts on behalf of); and
     c) Maintaining a sales office (in public)
  2. The maintenance of inventory by an independent contractor will result in loss of immunity, whether on a consignment basis or other type of arrangement

Independent Contractors Continued…

- For purposes of applying independent contractor provisions, a sales or manufacturer's representative who exclusively works for 1 corporation is NOT considered to be an independent contractor:

  1. For the special rules to apply, the contractor must:

     a) Hold him or herself out to the public as soliciting orders for more than one principal; and

     b) Actually solicit orders for more than one business.

  2. Companies with common ownership, whether or not they are members of a unitary business or consolidated group, will not count as different businesses.

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