Sales and Use Tax

BY
WILLIAM M. FEEHLEY, CPA

Sales and Use tax overview

- Authority of States to collect sales tax
- Nexus and how it is determined
- Commerce Clause
- Due process Clause
- Maryland Sales Tax Overview
- Surrounding States

- Constitutional Rights

The US constitution and all state constitutions contain restrictions on the nature and scope of state and local taxation. The two most important US constitutional restrictions on state and local tax are the Due Process and Commerce Clause.

The Due Process Clause, whose roots can be traced back to the Magna Carta (1215) concerns itself with questions of fundamental fairness between a government and those over whom the government seeks jurisdiction.

The Commerce Clause imposes restrictions on states with regard to interstate commerce.

- Due Process Clause

The Fourteenth Amendment to the Constitution states “ Nor shall any state deprive any person of life, liberty, or property, without due process of law….”

With respect to sales and use tax the Due Process refers to the links, contacts, or nexus, both quantitative and qualitative, between a state and the object or person over which the state attempts to assert jurisdiction.

The Supreme Court has provided two tests for Due Process

1. a minimal connection or nexus and

2. a rational relationship between the income attributable to the State and the intrastate values of the enterprise.

This over the years has come to mean that a seller may have income tax nexus without having sufficient nexus to be subject to the sales and use tax.

The Commerce Clause

It is one of the specific constitutional powers assigned to congress “The Congress shall have the power … to regulate commerce with foreign nations, and among the states and with Indian tribes”.

The Commerce Clause does not restrict discrimination among and between businesses and industry; it only prohibits discrimination against interstate commerce.

In 1977, the Supreme Court provided a four part test to determine whether or not a state tax on interstate commerce is constitutional.

- The tax will pass constitutional muster if

  1. The tax is applied to an activity with a substantial nexus with the taxing state

  2. The tax is fairly apportioned

  3. The tax does not discriminate against interstate commerce and

  4. The tax is fairly related to the services provided by the state.

Since Quill, the arguments have turned on (1) how much physical presence is substantial

(2) Is physical presence the same thing as substantial nexus and (3) is physical presence needed at all.

Over the course of time Sales tax rules followed the Commerce Clause while income tax rules have followed the Due Process Clause.

Because Congress has the authority to regulate interstate commerce, but not to modify the safeguards of the Due Process Clause, the separation of the two strands of restraint frees the legislature to decide at any future time the extent to which states may subject interstate vendors to use tax collection duties.

To date Congress has never stepped into the middle of this debate and has allowed the courts to handle all issues related to both the Due Process and Commerce Clauses.

- Multi State Tax Commission

On October 17, 2002 the Multistate Tax Commission (MTC) approved a proposal that urges the states to adopt a new uniform nexus standard applicable to both sales and income taxes. Under the new proposal, “business activity” tax nexus would be created if, during the tax year, a company (1) owns in the state more than $50,000 in property; (2) incurs more than $50,000 in payroll; (3) generates more than $500,000 in sales; or (4) exceeds 25 percent of total property, total payroll or total sales in the state.

Congress must repeal the Supreme Court decisions in Quill and National Bellas Hess for this standard to take effect.

- Marketplace Fairness Act of 2013

This act got the closest to passing of any previous bill before Congress but it died in the House Judiciary Committee.

What constitutes nexus for sales and use tax purposes?

The Supreme Court held in Quill that physical presence was to be the bright line test for sales and use tax. If a seller has no physical presence in the state it cannot be required to collect tax on its sales into that state.

Two questions have been debated since the Quill case

1. How much physical presence is sufficient to create nexus?

The Supreme Court has stated that the physical presence must be more than the “slightest presence” to rise to a standard of constitutional nexus.

2. Should the physical presence test be replaced with economic presence test?

This question is answered yes by most states and no by most companies. The Supreme Court will hopefully giving us guidance some time this year.

Background

Under the contested legislation, certain remote sellers that sell tangible personal property, products transferred electronically, or services for delivery into South Dakota are subject to the state's provisions governing the retail sales and service tax and uniform municipal non-ad valorem tax, and are required to remit sales tax as if they had a physical presence in the state.[4] Remote sellers are subject to these provisions if they meet one of two thresholds in either the previous calendar year or the current calendar year:

- The seller's gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota exceeds $100,000
- The seller sold tangible personal property, any product transferred electronically, or services for delivery into South Dakota in 200 or more separate transactions[5]

The legislation explains that it is intended to directly challenge *Quill* and provides expedited court procedures for litigating this matter. Although the legislation was scheduled to take effect on May 1, 2016, it was enjoined prior to its effective date. A circuit court granted the remote sellers' motion for summary judgment, holding that the legislation "fails as a matter of law to satisfy the physical presence requirement that remains applicable to state sales and use taxes under *Quill* and its application of the Commerce Clause."[6] The legislation provides that any appeal goes directly to the South Dakota Supreme Court and must "be heard as expeditiously as possible."[7]

In a 5 to 4 decision the Court ruled that physical presence is not the only determining factor for whether or not a company needs to charge and collect sales tax and that the Quill decision does not apply to the ever changing economy and that South Dokota's following of the Streamlined Sales Tax Act gave small retailers an out on the collection of the tax.

Basically, the act requires $100,000 in sales or 200 transactions or 40% of a company's revenue to be in the state during the previous calendar year to make the seller subject to the state sales tax.

How does nexus differ for income tax purposes vs sales tax purposes

Nexus for income tax is usually created whenever the out of state seller exceeds the safe harbor provisions in Public Law 86-272.

Public Law 86-272 only pertains to the solicitation sales of tangible personal property. Enacted in 1959 this law prevented companies from being subject to multistate taxes for soliciting sales.

When a client begins to cross the state line while doing business be sure to look at both income tax as well as sales tax.

WHO BEARS THE TAX

Who is responsible for either collecting or paying the tax. 45 states impose a sales tax on the retail sale of tangible personal property. These taxes have various names including privilege tax, gross receipts tax, consumer tax and retail sales tax..

What ever the tax is called generally, the seller has the responsibility (assuming nexus exists) for collecting and remitting the tax to the state. In many states the purchaser remains liable for the tax until it has been paid by the seller. What this implies is the state can go after the purchaser if the seller does not remit the taxes collected. There has never been a case where the state went after the purchaser for taxes he had already paid but the liability still exists. This could also add to collection costs to recover the taxes from a customer that uses credit.

Additionally, a seller who does not collect and remit sales tax and does not file the appropriate forms could be liable for many years since the statute of limitations does not start until the forms have been filed.

What activities of an out of state vendor would create a duty to collect state taxes?

People- Employees, independent contractors, and third party can all create sufficient physical presence to trigger nexus. An employee regularly working in a state will create nexus in every state. If an independent contractor, rather than an employee, is consistently and regularly working in a state performing the same activities as an employee, nexus is almost guaranteed.

Does an out of state retailer create nexus when it makes deliveries into another state in its own trucks? Due Process requires some definite link, some minimum connection, between the state and the person, property or transaction it seeks to tax. Occasional deliveries of goods in the sellers own trucks may not be sufficient to create nexus. Most states have agreed that one delivery per month is the maximum amount to keep from creating nexus.

In 28 states the licensing of software creates nexus for sales and use tax. Maryland is one of the 28 states. Virginia and West Virginia are also part of the 28.

Which activities do not result in a duty to collect sales tax?

Must the sales tax be separately stated?

Yes the sales tax must be separately stated in 30 states including Maryland, Pennsylvania, DC, Virginia and West Virginia.

What should the vendor do if there is a question as to liability of sales tax?

Most state statutes provide that the vendor should collect the tax. If the buyer believes that the transaction should not have been taxed than they can file for a credit and claim for refund.

Which types of charitable organizations are exempt from sales tax?

DC- 501(c) 1 and (c) 3

MD- 501(c)3, (c) 4 and (c) 13

PA- Must apply directly to PA Dept of Revenue and must be a public charity

VA- 501(c) 3, and (c) 4

WV- Exempt only under certain circumstances

What is an exemption (resale) certificate?

Most states require the purchaser to provide a certificate to the seller when items purchased are exempt from tax. The reselling of goods is a valid exception as long as the purchaser has a valid sales tax license and provides the seller with a written certificate.

How long are the certificates valid?

In most states a Blanket Certificate is good until it is revoked. This applies to all states surrounding MD except West Virginia where the certificate must be updated annually.

Are Illegal sales subject to sales and use tax?

Yes. State sales and use tax statues do not distinguish between legal and illegal sales, so both are subject to tax.

Method of Accounting

Taxpayers may elect to use the cash, accrual or a hybrid method of accounting.

Some states require the use of the accrual method of accounting and these states include Maryland, Pennsylvania, Virginia. The reason behind this is the tax is due on the sale not on the collection. If you pay taxes on the sales and later are not able to collect the money then you are entitled to a credit on the future tax for the write off of bad debts.

Some states require that the taxpayer use the same method of accounting that is used on their federal income tax return. Most all states require special permission to use the cash method and this requires the filing for a special exemption.

Another issue is the use of 3rd party collection companies. If the debt is non collectible then does the 3rd party have a right to a credit for the uncollected tax? The court have ruled that once the debt is transferred the original seller has been paid the tax and the 3rd party is the holder of a contract. These contracts are not subject to tax therefore no credit is given for the non collection.

THANKS FOR ATTENDING

Contact Information

Bill Feehley, CPA

bill@accuratebusiness.com

410-515-5800