State and Local Tax Considerations for Nonprofits

July 26, 2012

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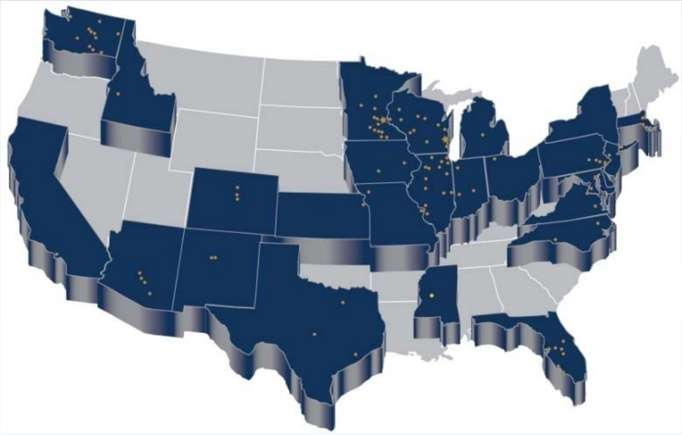

Speaker Introductions

Karen Gries, CPA - Partner

Karen provides tax compliance and consulting services to exempt organizations. She has 25 years of public accounting experience focusing on serving the needs of exempt organizations.

Ellen McCabe, CPA – Tax Partner

Ellen provides multistate tax services to the Firm's clients in all areas of state and local tax, including income/franchise, sales and use, tax incentives, employment tax, unclaimed property, and personal property.

Mike Herold, J.D. - Principal

Mike provides services to the firm's clients in the areas of state business, income and franchise tax, sales and use tax, unclaimed property and personal property tax.

Learning Objectives

At the end of this learning session, you will be able to:

- Understand some of the complexities related to State and Local Tax Nexus and how this applies to nonprofits
- Understand general income tax concepts for nonprofits
- Understand general sales and use tax considerations for nonprofits
- Be familiar with state registration requirements related to solicitations
- Consider unclaimed property reporting requirements for your organization

If Tax Exempt - Why Worry About State Tax?

The term nonprofit and tax exempt are not one in the same!

Each state has different rules and requirements related to the taxation of nonprofits. Understanding these rules and filing requirements is critical to your organization.

State and Local Tax Considerations

- Does the organization have nexus - connection that allows a state to impose a tax?

- If the organization does have nexus, what exemptions apply for:

  Sales Tax

  Income Tax

  Franchise Tax

  Gross Receipts Tax

State and Local Tax Considerations

- What other state compliance requirements should be given consideration?

  Registration for solicitation

  Unclaimed funds

  Other miscellaneous filing requirements

State Tax Nexus and Income Tax Considerations

Presenter:

Ellen Q. McCabe

Nexus – A Four-Step Analysis

1. Where does the organization have nexus?
2. What taxes can be imposed on the organization once nexus is established?
3. Is there a need to register as a nonprofit or apply for a separate state nonprofit determination?
4. How are the taxes/fees computed?

Nexus and Expanded Powers of the State

Nexus is the amount and degree of business activity that must be present before a state can tax an entity's income

Nexus and Expanded Powers of the State

Nexus standards vary by tax type

- Sales tax – Physical presence
- Income tax – Physical presence or economic presence
- Franchise tax – Physical presence

States are testing the waters and expanding their nexus provisions

What is Economic Nexus?

Economic Nexus generally is created by the purposeful direction at a market with significant sales or benefits derived by these activities

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What Activities Create Nexus?

- Individuals/activities in other states
  - Professors conducting on line training from their in home office
  - Editors of a trade publication working from their in-home office outside of the organization’s home state
  - Travel outside one’s home state to run or participate in charitable functions
  - Speaking engagements
  - Research assignments
  - Development officer’s travel to various states

What Is Substantial Nexus?

- What amount of trips or number of days outside of one's home state creates nexus?
  - There is no certain number of days. If the activity is regular and systematic and related to the organization's overall purpose
  - De minimis standard : Activities when taken together establish only a trivial connection with the taxing state

What Taxes Apply Once Nexus Is Determined?

Generally:

- Most states will accept the federal tax exempt status under IRC Section 501
- Many states require separate registration in order to receive tax exempt status
- Most states will subject unrelated business income to tax
- Franchise and taxes on capital generally will not apply if tax exempt for state purposes

For Example:

California:

- Form FTB 3500 must be filed to obtain CA tax exemption
- Income tax is imposed on UBIT

For Example:

North Carolina:

- Foreign organizations must register with the secretary of state
- Requires a determination letter to be considered tax exempt
- Income tax on UBIT does apply
- Franchise tax does not apply if tax exempt

Computation of Tax on Unrelated Business Income

- Unrelated Business Income (UBI) must be split between the states in which the organization has nexus
- Income is apportioned amongst the states using a percentage of the organization's instate activity versus out of state activity

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Computation of Tax on Unrelated Business Income

Total unrelated business income (UBI)

X

State apportionment factor

equals

State apportioned Income

X

The applicable tax rate

equals

Unrelated business income tax (UBIT)

Apportionment Factor - Unrelated Business Income

- The apportionment factor = the instate property, payroll and sales that generated unrelated business income divided by the organization's total property, payroll and sales that generated the unrelated business income

- Many states more heavily weight the sales factor or apply a 100% sales factor in determining the income apportioned to the state

Apportionment Factor - Unrelated Business Income

- Property is sourced to the state where the property physically resides. Rent expense is generally capitalized at 8X the amount.

- Payroll is sourced to the state where the employee is performing the services.

Determination of Receipts by State

- States vary in how they source sales to a state

  - Receipts from the sale of tangible property are most often source based on the “final destination”

  - Receipts from services are sourced either based upon the cost of performance or utilizing a market approach

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Determination of Receipts by State – Example

- Cost of performance – looks at where the underlying cost of the income producing activity occurs

- Market approach looks at where the customer is located or where the benefit is received

The difference in state sourcing rules can result in a sale being sourced nowhere or being sourced to two states

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Determination of Receipts by State – Example (con't)

- Example:

  A trade association publishes a newsletter and has unrelated business income from advertising revenue associated with this publication.

  Where are the receipts related to this advertising revenue sourced?

Determination of Receipts by State

Cost of performance – Sourcing would be to where the underlying work is being performed

Market approach – Sourcing would be to where the end customer is located (based on subscriptions)

Determination of Receipts by State – Example (con't)

Additional Facts:

- The work is all performed in states that follow a market approach to sourcing revenues
- All of the publications are being shipped to a cost of performance state

Determination of Receipts by State – Example (con't)

The sales factor numerator is zero!

- No sales are attributed to the states where the services are being performed since none of the publications are being shipped to these states
- No sales to the customer's home state since no work is being performed in that state

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Apportionment Opportunities

The overall tax liability can be greatly reduced by taking advantage of the different state by state rules for apportioning business income!

But be careful … these rules can also result in double taxation

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What does this mean for your organization?

- Determine where the organization has nexus
- Understand the administrative requirements of any states where the organization does have nexus
- Ensure tax on UBI is being handled properly. ***There are opportunities to reduce tax!***
- Continually monitor the ever changing state and local rules related to the taxation of nonprofits

Nonprofit Sales Tax

Presenter:

Mike Herold, JD

Overview

- What does it mean to be a nonprofit?
- Three distinctly different viewpoints:
  - Nonprofit organization
    - ◊ Tax exempt
  - The IRS
    - ◊ No federal income tax on related activities
  - The states-
    - ◊ No income taxes, but limited or no sales tax and property tax protections

Number One Rule For All States

- All sales of tangible personal property and some services are taxable unless a specific exemption exists
  - Does the state recognize the IRS tax exempt status of the nonprofit for sales and use taxes?
  - For nonprofits, does this mean purchases are exempt from sales and use tax?
  - Is the nonprofit required to collect tax on the sale of goods?

Providing Charitable Services

- Many states allow nonprofits to be exempt for sales/use tax if the nonprofit engages in charitable activities
- The test is whether products or services are delivered based on the recipient’s ability to pay

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Special State Requirements

- Some exemptions are limited to 501(c)(3) organizations
- Other states are more broad allowing exemption to other 501 entities
- Some states simply honor the federal exemption without more action by the nonprofit
- Others require a special state application for a sales tax exemption.

<u>An organization cannot assume a 501(c)(3) is automatically exempt from sales and use taxes</u>

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Examples

- AZ and ID have no exemption for religious organizations
- AL, AR, CA, LA, MS have no tax exemptions for 501(c)(3) organizations
- IL, MN, and NE exemptions only for those deemed to be exclusively religious, educational or charitable
- PA must be "purely public charity"

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Some States Tax Nonprofit Organizations

- Many states tax nonprofit organizations with some specific exemptions:
  - AL, AR, AZ, CA, GA, IA, ID, LA, ME, NC, ND, NE, OK, SC, SD, TN, and WA

States With More Favorable Exemptions

- These states have more favorable exemptions for nonprofit organizations:
  - CO, CT, DC, HI, IL, IN, KS, KY, MA, MD, MI, MO, MS, NJ, NM, NV, NY, OH, PA, RI, TX, UT, VA, VT, WV, WY

Sales By Nonprofits

- States consider sales of tangible personal property as taxable
- Even nonprofits may be required to collect sales tax on sales of tangible personal property
- Exemptions
  - Fundraising
  - De minimis sales
  - Product itself is exempt

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Nonprofit Purchases

- Nonprofit purchases are presumed taxable unless a specific exemption exists
- The most common exemption is for the purchase of goods used in the charitable purpose
  - software, office equipment & furniture, supplies, etc.
- Exemption certificates should be issued to suppliers where appropriate
- Don't assume that because no tax was assessed on an invoice that the product is exempt

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Questions When Doing Business in a State

- Do you have nexus in a given state?
- Are you required to specifically apply for a sales/use tax exemption?
- What are the limitations of the exemption?
  - Purchases used for exempt purpose?
  - Sales of tangible personal property or services?
  - Fund raising exemption?
  - Filing requirements for subsidiary or disregarded entity?
  - Intercompany transactions?

Property Tax

- Property tax exemptions may exist for nonprofits who qualify for the sales and use tax exemption
- States are becoming much more diligent in issuing and challenging property tax exemptions
- If property is used in both exempt and UBI activities, the property tax may be assessed on the unrelated portion

Record keeping

- Clear record keeping is required to show whether the purchases or sales follow within the narrow sales/use tax exemptions
- Fundraising should be tracked separately from other activity
  - Especially important when states have a specific dollar or number of days threshold for the fundraising exemption
- Sales should be closely monitored when products or services are similar to other "for-profit" entities

Solicitation and State Registration Requirements

Presenter:

Karen Gries

Charitable Sector Self-Regulation

- Charitable sector continues to be highly self-regulated
- IRS increases its role in the charitable sector with the redesigned Form 990
- Attorney General has the role of protecting assets held for charitable purposes

Charitable Organization Regulation

- All 50 states and DC regulate nonprofit organizations
  - Some states are more active than others
- 39 States and DC have laws governing charitable solicitations or registration/licensing of exempt organizations

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Who Must Register?

- The nature of activities along with the laws of the State determines who must register
  - Solicitations – charitable contributions or program service revenue
    - ◊ Mail
    - ◊ Internet
    - ◊ Phone
    - ◊ Social media
  - Fundraising events
  - Use of professional fundraiser
- May go beyond solicitation by 501(c)(3) organization solicitations

Solicitations

- State of Minnesota defines a solicitation as:
  - "Solicit" and "solicitation" mean the request directly or indirectly for any contribution, regardless of which party initiates communication, on the plea or representation that such contribution will or may be used for any charitable purpose, and include any of the following methods of securing contributions:
    - ◊ MN Statute 309.50

Why Should a Nonprofit Register?

- States are increasing regulation activities
- Fines may be imposed
- Board of Director’s fiduciary responsibilities
- Public accountability
- Donors and grantors are becoming more active in monitoring
- Enforcement by regulators
- Court action
- It’s the law within the state

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Registration of Professional Fundraisers

- Many states require a professional fundraiser to register before providing services to charities soliciting in the state – again statute differs by state
- Failure of a professional fundraiser to register may impact the charitable organization's registration

Cost of Registration

- Fees paid to each state varies
- Staff time or professional services associated with the registrations – not uncommon for responsibilities to be a significant portion of staff time
- Many states require a registered agent
- Lack of uniformity creates increased costs
  - Financial statement submission
  - Separate forms
  - Different due dates
  - Extension provisions differ

Compliance is a Multi-Step Process

- Quantify the activities
  - What are the registration requirements within the organization's home state?
  - What activities are conducted outside of the organization's home state?
  - Does the organization send solicitations to multiple jurisdictions?
  - How does the organization utilize social media?
  - Is the organization's website interactive?
  - Does the organization utilize a professional fundraiser?

Compliance is a Multi-Step Process (con't)

- Assess the risk
  - What states have the most activity?
  - Are any activities of a higher profile than others?
  - What is the risk of non-compliance?
- Remember any solicitation within a state requires registration
- A risk based approach assists in determining the exposure of non-compliance

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Compliance is a Multi-Step Process (con't)

- Determine the states requiring registration based on the earlier process
- Utilize the Uniform Registration Statement
- Annual compliance
  - Enlist professional assistance or designate internal resource
- Visit –
  - National Association of State Charity Officials
  - National Association of Attorney Generals

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Unclaimed Property

Presenter:

Mike Herold, JD

What is Unclaimed Property?

- Intangible personal property that has remained unclaimed by the rightful owner for a specified period of time
- Governed by the states
- The idea is the state will hold the property in trust for the rightful owner

Traditional Types of Property

- Uncashed checks
- Deposits
- Customer credits
- Refunds
- Dormant accounts
- Retirement assets
- Worker's comp
- Accounts payable
- Unpaid dividends
- Tangible property
- Commissions
- Rebates
- Uncashed payroll
- Unidentified cash/credits
- Other general ledger items

Unclaimed Property is Not a Tax!

- Nexus does not apply
- Generally no statute of limitations
- Record retention requirements
- Few states have formal administrative appeals
- Use of third party contract auditors
- Applies to nonprofits and even the federal government
- Limited nonprofit exemptions in KY and OH

Steps in Unclaimed Property

- Identify property rightfully belonging to another
- Due diligence requires entity try to make contact with the property owner
- If no contact was made within a specific period of time (dormancy period), then property becomes "unclaimed"
- A report and property is required to be remitted to the proper state

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Examples of Dormancy Periods

- Unclaimed payroll check 1 year
- Unclaimed checks from general disbursement account 3 years
- Credit memos or account receivable credit balances and refunds 3 years

Once this period of time has elapsed, the funds must be turned over to the state

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Identifying the Proper State

Main sourcing rules

1. Last know address of the property owner
2. Place of incorporation

Why Should Organizations File?

- Increasing audit activity
  - Michigan has announced aggressive pursuit beginning 1/1/13
- Successor liability
- Increasing number of contingent fee auditors
- Material financial consequences
- Whistleblower statutes

Developing Issues

- Dormancy periods are decreasing
- Increased audit activity
- New property types
  - Health Savings Plans
  - Traditional IRA
  - Roth IRA
  - Educational Savings Account
- Increasing legislative awareness

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Questions

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