Multistate Tax Update -- January 9, 2014

ALERT | JAN 09, 2014

McDonald Hopkins hopes the readers of the *Multistate Tax Update* enjoyed a joyous holiday season and look forward to a prosperous 2014. In 2013, McDonald Hopkins launched the *Multistate Tax Update* to keep you informed regarding recent developments in the state and local tax area. We have been overwhelmed with the response to our *Multistate Tax Update* in 2013 and look forward to bringing you new developments in 2014. We appreciate your readership and encourage your feedback as we continue to cover the ever-evolving area of multistate taxation.

A SIGN OF THINGS TO COME? AMAZON BEGINS COLLECTING SALES TAXES IN INDIANA, NEVADA AND TENNESSEE IN THE NEW YEAR

Amazon customers in the states of Indiana, Nevada and Tennessee may notice a new line item added to their Amazon purchases—sales tax. While this may not seem like a significant change—as customers are legally required to pay use tax on these items in lieu of sales tax—this is a further indicator of the significant changes that are likely to continue in the arena of online retailer sales tax. Customers are poor payers of use taxes, while businesses, such as Amazon, are proficient at collecting and remitting sales tax. Customers often avoid payment by not reporting or underreporting the amount of use taxes they owe each year, either by design or through mere forgetfulness. As Indiana State Senator Luke Kenley stated, "[t]he problem is that most people don't bother to think about [use taxes] or worry about [them]."

The problem that Senator Kenley articulates has been echoed by many state and federal lawmakers. It is difficult for customers to keep track of every online purchase they make. For example, a taxpayer may make dozens of online purchases throughout the year. However, a big box retailer, such as Best Buy and countless others, already charges the customer sales tax. Online-only retailers, such as Amazon, likely are not charging the customer sales tax on his or her purchases. Do you remember where you made your last online purchase and whether you were charged sales tax on the item that you purchased? What about the coffee maker you bought online in January, that new laptop and countless peripherals and accessories you bought from numerous retailers from February through April, as well as your many other online purchases? Appropriately paying use taxes requires the average consumer to keep detailed records for all online purchases, not just significant purchases. However, while paying use tax can be burdensome, customers are required to follow these laws.

As a result of customers' poor track record of paying use tax, state lawmakers have pushed online retailers to collect and remit sales tax by enacting new legislation or by entering into agreements with online retailers. The agreement method was how Amazon came to become a sales tax collector in Indiana, Nevada and Tennessee.

In Indiana, Amazon agreed in 2012 to a deal that it would begin collecting sales tax on Jan. 1, 2014. In Nevada, a similar deal was reached in 2012, where Amazon agreed to start collecting state sales tax by 2014. In Tennessee, a deal was reached where Amazon would not be required to collect sales taxes until 2014. Amazon also agreed to build two distribution centers in Tennessee, which were estimated to create approximately 3,500 jobs. In each case, it appears that Amazon did not have the requisite physical presence in the state to be required to collect and remit sales tax. As in the past, Amazon successfully gained a deferral of its obligation to collect sales taxes while agreeing to begin to collect such taxes at a future date (often moving into the states it concedes to in an effort to further improve its internal logistics and delivery times).

The *Multistate Tax Update* has continued to follow Amazon through its sales tax journey, as its journey has largely been a symbol of things to come in connection with online retailing and one of great national interest. The Amazon sales tax story has also been an especially compelling one, as the company has supported the collection of sales tax on out-of-state purchases, granted concessions to states where it may not otherwise have been compelled to collect sales tax and also staunchly opposed laws which would require it to collect sales tax (at times with all three discrete positions being made concurrently by the retailer in various forums).

NORTH CAROLINA: DEPARTMENT OF REVENUE ISSUES DIRECTIVE REGARDING NEW SALES AND USE TAXES APPLICABLE TO SERVICE CONTRACTS

The New Year also brought an expansion of North Carolina's sales tax base to include sales of retail contracts. The underlying law (**Session Law 2013-316**) was enacted on July 23, 2013 and the sections applicable to sales tax on service contracts became effective Jan. 1, 2014.

On Dec. 23, 2013, the North Carolina Department of Revenue (the Department) issued Directive **SD-13-5** (the Directive) which provides guidance on many of the aspects of sales tax applicable to service contracts. In the Directive, the Department discusses the changes to sales and use tax laws applicable to service contracts, provides an explanation of many key legal terms, and provides useful examples.

The relevant law, N.C. Gen. Stat. § 105-164.4(a)(11), imposes the 4.75 percent general state and applicable local and transit rates of sales and use tax "to the sales price of a service contract" sold by a retailer on or after Jan. 1, 2014 and sourced to North Carolina. This may sound simple but the law's terms carry legal baggage.

For instance, a *service contract* is defined as "[a] warranty agreement, a maintenance agreement, a repair contract, or a similar agreement or contract by which the seller agrees to maintain or repair tangible personal property." N.C. Gen. Stat. § 105-164.3(38b). *Tangible personal property* is "[p]ersonal property that may be seen, weighed, measured, felt, or touched or is in any other manner perceptible to the senses. The term includes electricity, water, gas, steam, and prewritten computer software." N.C. Gen. Stat. § 105-164.3(46).

However, N.C. Gen. Stat. § 105-164.4(a)(11) does not consider a single repair transaction between a retailer and a purchaser for tangible personal property that is not completed pursuant to a "service contract" sold to a purchaser to be a service contract for sales tax purposes. Also, sales and use tax does not apply to a contract where a person agrees to maintain, service or repair real property or an item of tangible personal property permanently attached to real property. The example provided by the Department of a contract where

tangible property is affixed to real property and not subject to sales taxes is a service agreement for the periodic repair and inspection of an installed garage door. All services to the garage door, including repairs, sold by a garage door company are exempt from sales and use tax.

Also note that the person ultimately liable for collecting and remitting sales tax might not be the end seller—it is the "retailer." As the Department clarified, "[a] retailer engaged in business in the State that sells a 'service contract' at retail sourced to this State is liable for the sales and use tax due on such transaction. A retailer that enters into an agreement or contract or otherwise authorizes, another person to sell or enter into a 'service contract' sourced to this State on the retailer's behalf, is engaged in business as a retailer in this State." If you are unsure whether you are the liable "retailer," we recommend that you seek the advice of legal counsel so that you understand your obligations and underlying business liability. The Directive also covers additional definitions which are crucial to this analysis. The matter of where a sale of a service is sourced is also another legal determination that should be analyzed, as well as if there are any applicable exemptions.

Just because your business entered into a service contract prior to Jan. 1, 2014 does not necessarily exempt the transaction from the new law. For service contracts that were entered into prior to Jan. 1, 2014 but are billed on a monthly or other periodic basis after Jan. 1, 2014, this new sales tax law is applicable. The new tax applies to the first billing period that: (1) is at least 30 days after Jan. 1, 2014; and (2) starts on or after Jan. 1, 2014.

The Department provided a general illustration of how this sales tax may apply in one of its examples. If you have ever purchased a new or used car from a dealer, you are likely aware of the extended warranty contracts that the dealer offers. The following is the Department's example regarding the purchase of a service contract for a new car:

> On January 15, 2014, a new car retailer sells a new motor vehicle for $45,000 to a purchaser. The new car retailer also sells, on behalf of a new car manufacturer, an extended warranty agreement for $2,000 to the purchaser. The new car retailer receives a commission on the sale of the extended warranty agreement from the new car manufacturer. The extended warranty agreement provides that the new car manufacturer will maintain or repair the motor vehicle for a three-year period and the purchaser of the contract will not be charged for an item used to maintain or repair the motor vehicle. The sales price of $2,000 paid for the extended warranty agreement executed by the new car retailer with the purchaser on January 15, 2014, on behalf of new car manufacturer, is subject to the 4.75% general State and applicable local and transit rates of sales and use tax. The new car manufacturer is the person liable for remittance of the sales and use tax to the Department.

Furthermore, the Department explained that when a service is actually performed under such a service contract:

> The sale, purchase, or withdrawal from inventory of parts by the new car retailer or other person to maintain or repair the motor vehicle on or after January 1, 2014, pursuant to the extended warranty agreement, are exempt from tax.

Note that if you are a retailer of "service contracts" that is not registered to collect and remit sales and use tax, you should complete form NC-BR, Business Registration Application for Income Tax Withholding, Sales and Use Tax and Machinery and Equipment Tax. There is no fee to register.

SOUTH CAROLINA: DEPARTMENT OF REVENUE SAYS SAME-SEX MARRIED COUPLES MUST FILE SEPARATE TAX RETURNS

On Jan. 2, 2014, the South Carolina Department of Revenue (the Department) issued **S.C. Revenue Ruling No 13-Draft/1/2/14** (the Ruling). In the Ruling, the Department addressed how individuals in a same-sex marriage recognized by the IRS must file their South Carolina income tax returns.

South Carolina joins an increasing majority of states that have issued guidance—that same-sex married couples must file separately. The Department noted that South Carolina does not recognize same-sex marriage on both constitutional and statutory grounds. So while South Carolina law requires in most instances that heterosexual married couples file using the same status as such couple used in filing their federal tax return(s), this does not apply to same-sex married couples filing income tax returns in South Carolina because the state does not recognize their marriage.

The Department gave the following directions to same-sex married couples who filed jointly for federal income tax purposes when filing their income tax returns in South Carolina:

- Each individual must file a separate South Carolina income tax return using Form SC 1040
- Each individual must claim a status of single, or, if qualified, head of household
- To prepare Form SC 1040, each individual must first prepare a "separate" federal income tax return for South Carolina purposes only (pro forma federal income tax return) using a filing status of single or head of household (if qualified) and complete it as though the individual is not married

The Ruling indicates that further guidance on filing 2013 income tax returns will be posted on the Department's website in the near future.

The *Multistate Tax Update* will continue to follow developments in the wake of the U.S. Supreme Court's ruling in *United States v. Windsor*, as well as Revenue Ruling 2013-17 (holding, in part, that: (1) "husband" and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage; and (2) a marriage of same-sex individuals that was validly entered into in a state whose law authorizes the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages). These holdings have only begun their ripple effect throughout the United States at both the federal and state levels. To be sure, a multitude of state legislation, rulings, guidance, and litigation will continue to ensue as a result. If you have questions on how these holdings or other developments may affect you or your business, please contact us.

For additional information regarding these subjects or any other multistate tax issues, please contact:

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