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ACUA - AuditCon:

Developments in Tax Reform and State and Local Tax Matters –

Where Should an Internal Auditor Focus

September 17, 2019

Notice

The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

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

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Agenda

1. Excise Tax on Excess Compensation and Notice 2019-09
2. UBIT "Silo-ing" and Notice 2018-67
3. Qualified Transportation Fringe UBTI and Notice 2018-99
4. Areas of IRS Examinations and Focus
5. Wayfair – Colleges and Universities

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Excise tax on excess compensation

Statute

Section 4960 – Tax on excess tax-exempt organizations executive compensation:

(a) Tax imposed. There is hereby imposed a tax equal to the product of the rate of tax under section 11 and the sum of—

(1) So much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000, plus

(2) Any excess parachute payment paid by such an organization to any covered employee.

For purposes of the preceding sentence, remuneration shall be treated as paid when there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such remuneration.

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Interim guidance under § 4960

- IRS Notice 2019-09
  - Treasury and the IRS issued on December 31, 2018
  - Provides interim guidance on addressing frequently asked questions on the application of § 4960
  - States that Treasury and the IRS intend to publish proposed regulations under § 4960
  - Until proposed regulations are issued, taxpayers may use any good-faith, reasonable interpretation of § 4960 and rely on the guidance under Notice 2019-09
    - The notice identifies several positions that Treasury and the IRS have determined are not consistent with a good-faith, reasonable interpretation of the statute

Common law employer liable for the excise tax

According to Notice 2019-09:

- The common-law employer, as determined generally for federal tax purposes, is liable for the excise tax imposed under § 4960
- A payment to an employee from a related or unrelated entity for services rendered to the common-law employer is considered a payment to the employee from the common-law employer
- *Takeaway:* The issuer of the Form W-2 is not necessarily determinative

What is an applicable tax-exempt organization (ATEO)?

— Organizations exempt from tax under section 501(a),
— Exempt farmers' cooperatives (section 512(b)(1)),
— Political organizations (section 527),
— Organizations that have income excluded from gross income under section 115(1).

What is remuneration?

— Wages under section 3401(a) (compensation subject to federal income tax withholding) and amounts included in gross income under section 457(f),
— No substantial risk of forfeiture,
— Remuneration paid to the employee by the ATEO plus any related persons or governmental entities,
— Does not include remuneration paid to a licensed medical professional for the performance of medical services. According to Notice 2019-09,
  - Only remuneration paid for the "direct performance" of medical services to patients is carved out,
  - Compensation for teaching, research, or managing medical operations is not carved out,
  - Medical services are defined as medical care within the meaning of section 213(d).

What is an excess parachute payment?

- Payments contingent on an employee's separation from employment if the aggregate value of the payments equals or exceeds three times the employee's "base amount,"
- The "excess" is the payment over the employee's base amount,
- No dollar threshold (like $1M for excess compensation),
- Amounts paid to individuals that are not highly compensated per section 414(q) excluded,
- Amounts paid to licensed medical professionals for the performance of medical services excluded,
- According to Notice 2019-09,
  - Payments made by related organizations also taken into account,
  - Only involuntary separation triggers the excise tax.

Who are covered employees?

- Any employee who is one of the five highest compensated employees of the ATEO for the taxable year or was a covered employee of ATEO for any taxable year beginning after 12/31/2016.
  - Once a covered employee, always a covered employee.
  - ATEOs should start their list of covered employees for the first tax year beginning after 12/31/16.
- According to Notice 2019-09,
  - Each ATEO in a system of related organizations determines its covered employees separately but must take into account compensation paid by related organizations.
    - In determining covered employees, an employee cannot be considered one an ATEO's five highest compensated employees if the ATEO paid less than 10% of the employee's total remuneration (unless that ATEO paid the most remuneration)
  - Compensation defined as remuneration.

Tax year and effective date

- Excise tax will be determined based on the remuneration paid and excess parachute payments made in the calendar year ending with or within the tax year of the employer,
- The effective date of the excise tax is the first tax year of the employer beginning after 12/31/2017,
- Remuneration paid or vested prior to the start of that year is not subject to the excise tax.

UBTI "Silo-ing"

Internal revenue code section 512(a)(6)

Special rule for organization with more than 1 unrelated trade or business. In the case of any organization with more than 1 unrelated trade or business—

(A) Unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to each such trade or business and without regard to subsection (b)(12)

(B) The unrelated business taxable income of such organization shall be the sum of the unrelated business taxable income so computed with respect to each such trade or business, less a specific deduction under subsection (b)(12), and

(C) For purposes of subparagraph (B), unrelated business taxable income with respect to any such trade or business shall not be less than zero.

UBTI "silo-ing"

Summary: For tax-exempt organizations that carry on more than one unrelated trade or business activity—

— UBTI must be calculated separately for each unrelated trade or business activity

— Losses from one unrelated trade or business activity may not be used to offset income derived from another unrelated trade or business activity

— NOLs arising from an unrelated trade or business activity may only offset income from the trade or business activity from which they arose

Timing:

— Silo-ing required for tax years beginning after December 31, 2017

— This change does not apply to any NOLs arising in a tax year beginning before January 1, 2018. Such historical NOLs may be applied to reduce aggregate UBTI arising from all unrelated businesses.

Interim guidance

Notice 2018-67

Separate trade or business

- Congress did not provide criteria for identifying separate unrelated trades or businesses
- Treasury and the IRS intend to propose regulations for such determination
- Pending issuance of the proposed regulations, exempt organizations "may rely on a **reasonable, good-faith interpretation** of [IRC] § 511 through 514, considering all the facts and circumstances . . .."

North American Industry Classification System (NAICS)

- Use of NAICS 6-digit codes will be considered a reasonable, good-faith interpretation for these purposes
- Codes are currently used for Form 990-T, Block E
  - Range from 2 (broader) to 6 (more specific) digit codes
  - 2018 Form 990-T instructions allow reliance on NAICS codes in the instructions
- Notice 2018-67 requests comments regarding whether using less than 6 digits of the NAICS codes, or adding additional criteria, would appropriately identify separate trades or businesses for purposes of the new law

NAICS codes examples

- 621110 Offices of Physicians (5-digit code in the Form 990-T instructions)
  - 621111 Offices of Physicians (except Mental Health Specialists)
  - 621112 Offices of Physicians, Mental Health Specialists
- 621300 Offices of Other Health Practitioners (4-digit code in the Form 990-T instructions)
  - 621320 Offices of Optometrists
  - 621330 Offices of Mental Health Practitioners (except Physicians)
  - 621340 Offices of Physical, Occupational and Speech Therapists, and Audiologists
  - 621399 Offices of All Other Miscellaneous Health Practitioners
- 621400 Outpatient Care Centers (4-digit code in the Form 990-T instructions)
  - 621410 Family Planning Centers
  - 621420 Outpatient Mental Health and Substance Abuse Centers
  - 621492 Kidney Dialysis Centers
  - 621493 Freestanding Ambulatory Surgical and Emergency Centers

NAICS codes examples (continued)

- 621500 Medical and Diagnostic Laboratories (4-digit code in the Form 990-T instructions)
  - 621511 Medical Laboratories
  - 621512 Diagnostic Imaging Centers
- 446110 Pharmacies and Drug Stores
- 531120 Lessors of Nonresidential Buildings
- 541380 Testing Laboratories
- 541610 Management Consulting Services
- 541700 Scientific Research and Development Services (4-digit code in the Form 990-T instructions)
  - 541710 Physical, Engineering and Biological Research
  - 541713 Research and Development in Nanotechnology
  - 541714 Research and Development in Biotechnology
  - 541715 Other Physical and Biological Research

NAICS codes examples (continued)

- 561000 Administrative and Support Services (3-digit code in the Form 990-T instructions)
- 621610 Home Health Care Services
- 621910 Ambulance Services
- 722514 Cafeterias and Buffets
- 725515 Snack and Non-alcoholic Beverage Bars
- 713940 Fitness and Recreational Sports Centers
- 812930 Parking Lots and Garages

Interim rules for partnerships

Investment activities

— Treasury and the IRS intend to propose regulations treating all "investment activities" as one trade or business

— "Investment activities" should "capture only partnership interests in which the exempt organization does not significantly participate in any partnership trade or business"

Interim rule for investments through partnerships: In the case of partnership interest that meets a "***de minimis test***" or "**control test**"—

— An organization may aggregate its UBTI from the interest even if the partnership has multiple trades or businesses (including trades or businesses conducted by lower-tier partnerships)

— An organization may aggregate all such partnership interests and treat the aggregate interests as comprising a single trade or business

De minimis test

***De minimis* test**

— Organization must hold directly no more than 2% of the profits interest **and** no more than 2% of the capital interest of the partnership

— Organization does **not** meet the *de minimis* test if profits interests is not listed on the K-1

— Reliance on capital interest on the K-1 is acceptable but not required

Percentage Determination

— Take the average of the organization's percentage interest on the K-1 at the beginning and the end of the partnership's taxable year

— When determining percentages, the interest of a disqualified person (§ 4958), a supporting organization, or a controlled entity (§ 512(b)(13)) in the same partnership will be taken into account

- How will ownership percentages of disqualified persons be monitored?
- Partnerships will not know aggregate percentage interest for purposes of K-1s

Control test

Control test

— Organization must directly hold no more than 20% of the capital interest **and** not have control or influence over the partnership

— Average of percentages on K-1 may be relied upon, but not required

— Must take into account the interests of a disqualified person, a supporting organization, or a controlled entity

An exempt organization has control or influence if

— It may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership

- Could certain standard approval rights in a partnership agreement trigger this?

— Any of its officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business

— It has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees

Transition rule

Alternative transition rule

— For a partnership interest acquired prior to August 21, 2018, each partnership interest may be treated as comprising a single trade or business

— Unclear whether this transition rule may still be relied upon if ownership percentage increases after August 21, 2018

Aggregation

— Each directly-owned partnership interest is treated as a **separate** trade or business; such partnership interests *cannot* be aggregated together

— However, trades or businesses directly or indirectly conducted by any one partnership or by lower-tier partnerships may be aggregated

— In the case of separate partnership interests that qualify for the transition rule, may taxpayers aggregate trades or businesses conducted by the separate partnerships (or lower-tier partnerships) using NAICS codes (or other reasonable methods)?

Notice 2018-67

Other interim guidance

Treatment of qualified transportation fringe benefits (QTFs)

— Although included in UBTI under new IRC § 512(a)(7), QTFs are not considered an unrelated trade or business and are therefore not subject to the silo-ing provision

— If a tax-exempt organization has only one unrelated trade or business (e.g., partnership UBTI from K-1s) and UBTI from QTFs, it may aggregate the gains/losses

"Deemed UBTI"

— Notice 2018-67 states that Treasury and the IRS currently "see no distinction" between amounts included in UBTI under IRC § 512(b)(4) (unrelated debt-financed income), (13) (income from controlled entities), or (17) (certain insurance income) and amounts derived from an unrelated trade or business

— The Notice recognizes that aggregating income included in UBTI under such provisions "may be appropriate in certain circumstances"

IRS 2018 Form 990-T instructions

Separate UBTI calculation for each trade or business

— 2018 Form 990-T instructions state that an organization with more than one unrelated trade or business is—for each additional unrelated trade or business—to:

- Complete Part I and Part II on Page 1 of the Form 990-T for the first trade or business;
- Complete Schedule M for each additional trade or business; and
- Complete and attach statements containing the information required by Schedules A through K as necessary

Charitable contribution deductions

— Report the charitable contribution deduction in Part II of the Form 990-T (or Schedule M) "in any manner that results in full use of the allowable charitable deduction"

— If after reporting in Part II, an organization still has allowable charitable deductions remaining, it may use them to offset any section 512(a)(7) UBTI reported in Part III

New NOL deduction rules

New rules

— Use of NOL carryforward limited to 80% of taxable income
  - *Effective date:* Losses arising in tax years beginning after 12/31/17
  - Another reason pre-2018 and post-2017 NOLs must be tracked separately

— NOL carrybacks eliminated
  - *Effective date:* Losses arising in tax years ending after 12/31/17

— Indefinite carryforward of NOLs
  - *Effective date:* Losses arising in tax years ending after 12/31/17

Mismatch

— What is the result of these mismatching effective dates for a fiscal-year organization in first tax year ending after 12/31/17 (e.g., 9/30/18)?

— NOLs generated in that year are not subject to 80% limitation but may be carried forward indefinitely (and not carried back)

NOL ordering

What is the ordering rule when an organization subject to Section 512(a)(6) has pre-2018 and post-2017 NOLs?

— Notice 2018-67 and the Form 990-T and Form 990-T Instructions suggest that post-2017 NOLs will be calculated and taken into account before pre-2018 NOLs but requests comments

— UBTI for each separate trade or business is calculated before calculating total UBTI

— Violates the "first in, first out" principle that usually applies to NOLs

— Creates risks that pre-2018 NOLs will expire

Open questions

— What if pre-2018 NOL may be traced to a specific trade or business? May it be used when calculating UBTI for that trade or business silo?

— Is the 80% limitation applied separately within each silo in applying post-2017 NOLs generated within that silo?

UBIT Silo-ing

Other open questions

Becoming subject to silo-ing at a later date

— What if a post-2017 NOL is derived from an organization's only trade or business (so silo-ing does not apply at the time) but a second trade or business is subsequently started?
  - Is the NOL from the first trade or business applied in calculating the UBTI for that trade or business once it becomes silo-ed under IRC § 512(a)(6)?
  - May the NOL be used in calculating total UBTI, since it was derived when IRC § 512(a)(6) did not apply?

NOLs that an acquiring organization succeeds to in a merger or acquisition

— Does the acquiring organizations have to "fit" these acquired NOLs into a silo?

Silo-ed business sales

— What happens when the organization sells one or more of the unrelated trade or business silos?
  - May post-2017 NOLs from that silo be applied to any taxable gain from the sale of that trade or business?
  - May those NOLs be used to offset UBTI from other sources?

Qualified transportation fringe UBTI & notice 2018-99

Notice 2018-99

Parking expenses for qualified transportation fringes under § 274 and § 512(a)(7)

- IRS Notice 2018-99
  - Issued on December 10, 2018
  - Provides interim guidance on how to determine the amount of parking expenses that is nondeductible or treated as an increase in UBTI
  - IRS and Treasury intend to publish proposed regulations under § 274 and § 512
  - Until proposed regulations are issued, taxpayers may rely on the guidance under Notice 2018-99 to determine the nondeductible amounts and the increase in UBTI

Payments to a third party for parking

- Notice 2018-99 makes clear that if an employer pays a third party an amount for its employees to park at the third party's parking lot or garage and does not tax employees on this amount, the amount paid is included in UBTI
- But if the amount the employer pays to a third party for an employee's parking exceeds the monthly limitation on exclusion ($260 per employee for 2018), that excess amount
  - Is treated as compensation and wages to the employee
  - Is not treated as UBTI
    - See § 274(e)(2)

Payments to a third party for parking

Example

Example: Taxpayer A pays B, a third party who owns a parking garage across the street from A, $300 per month for each of A's 10 employees to park in B's garage, or $36,000 per year (($300 x 10) x 12 = $36,000)

— $31,200 (($260 x 10) x 12 = $31,200) is included in UBTI

— The excess amount of $40 per employee per month, or $4,800 ($36,000 - $31,200 = $4,800), is treated as compensation and wages and is not included in UBTI

Payments to a third party for parking

Questions

— Is a payment to a related party a payment to a "third party"?
  - Notice appears to assume payment to third party equals FMV
  - If payment to a related party is less than FMV, could IRS apply section 482 to increase UBTI?

— Related question: Is a payment to a partnership in which the tax-exempt employer is a partner a payment to a "third party"?
  - Aggregate vs. entity treatment

— Where does one draw the line between a payment to a third party so employees may park at a garage and a lease of parking spaces in the garage?
  - As we'll see, this could make a difference if some of the spaces being paid for are for the "general public"

Taxpayer owns or leases parking facility

- UBIT may be calculated using "any reasonable method"
- Using the value of employee parking to determine UBTI is not a reasonable method
- Notice establishes a *four-step method* that may be used as a safe harbor
- Applies if taxpayer owns or leases all or *a portion* of a parking facility
- If a taxpayer owners or leases more than one parking facility in a "single geographic location," the taxpayer may aggregate when using the four-step method
  - Examples suggest that a city is a single geographic location

What costs to include in UBTI?

- "Total parking expenses" include, but are not limited to –
  - Repairs
  - Maintenance
  - Utility costs
  - Insurance
  - Property taxes
  - Interest
  - Snow and ice removal
  - Leaf removal
  - Trash removal
  - Cleaning
  - Landscape costs
  - Parking lot attendant expenses
  - Security
  - Rent or lease payments or a portion of a rent or lease payment

What costs to include in UBTI

Questions

- What are reasonable methods for determining general maintenance, utility, tax, insurance, cleaning, landscape costs allocable to parking?
- How does one determine what portion of a rent or lease payment is allocable to parking if the lease does not separately break it out?
  - Determine the amount someone would pay for the parking spaces on an arm's length basis? (I.e., value?)
  - Determine landlord's costs allocable to the leased spaces?
    - Probably hard to obtain from landlords; also doesn't take into account the mark-up a landlord would charge

What costs *not* to include?

- Depreciation
  - Capital expenses are not specifically mentioned, but presumably a deduction for such expenses is denied under § 263, not § 274.
- Expenses paid for items not located on or in the parking facility, including items related to property next to the parking facility
  - Examples: landscaping or lighting
  - What about general administrative costs allocable to making parking available?

Taxpayer owns or leases parking facility

— The four-step method:

1. *Percentage of parking spots reserved for employee use.* This percentage of parking expenses is nondeductible under § 274(a)(4)
2. *Primary use of remaining parking spots.* If the primary use of the remaining parking spots is for the general public, the remaining parking expenses remain deductible
3. *Percentage of parking spots reserved for non-employee use.* If the primary use of the remaining parking spots is not for the general public, then the percentage of parking expenses attributable to reserved spots for non-employee use remain deductible
4. *Reasonable allocation of remaining parking spots.* Taxpayer must reasonably determine the employee use of any remaining parking expenses not specifically categorized in steps 1–3

Step 1

Parking reserved for employees

Determine the percentage of reserved employee spots in relation to total parking spots and multiply that percentage by the taxpayer's total parking expenses

— Employee spots may be exclusively reserved by, e.g., specific signage ("Employee Parking Only") or a barrier to entry or terms of access

— For tax years beginning on or after 1/1/19, a method that fails to allocate expenses to reserved employee spots cannot be a reasonable method

— *But,* until 3/31/19, organizations that have reserved employee spots may change signage, access, etc. to decrease or eliminate their reserved employee spots and treat those parking spots as not reserved employee spots retroactively to 1/1/18

Step 1

Reserved parking: Questions

- What about spots that are reserved for employees during normal business hours but open to students, patients, and/or visitors in off-hours?
  - Can taxpayer allocate some portion of the costs to off-hour use?
- What about spots reserved for "physicians" generally that include both employed and staff physicians (but not specific spots reserved for either)?
- How about a spot reserved for security employees?
  - If the spaces are reserved for security cars, these spaces would presumably be a working condition fringe, not a QTF, and expenses allocable to those spaces would not be included in UBTI

Step 2

Primary use by the general public

If the primary use of the remaining parking spots (after applying step 1) in the parking facility is to provide parking to the general public, then the remaining total parking expenses for the parking facility may be excluded from UBTI

- The "general public" includes (but is not limited to) students, patients, congregants, customers, clients, visitors, deliverers
  - Doesn't include the taxpayer's employees, partners, independent contractors
  - How about staff physicians? Employees of other employers?
- "Primary use" means greater than 50% of actual or estimated usage of the parking spots in the parking facility
- Primary use of the parking spots is tested during the normal hours of the organization's activities on a typical day
  - Non-reserved parking spots that are available to the general public but empty during normal business hours are treated as provided to the general public
  - If the actual or estimated usage of the parking spots varies significantly between days of the week or times of the year, the taxpayer may use any reasonable method to determine the average actual or estimated usage

Step 2

Use by the general public: Questions

- What are the "normal business hours" of a hospital or a university?
  - E.g., can one say a hospital operates on a 24-hour basis, even if use of the facility is less in the night-time hours?
- What is a "single geographic location" for purposes of aggregation?
  - Examples in the notice bless a city, but could this be extended to a metropolitan area?
  - May taxpayers "pick and choose" what parking facilities in a single geographic location they want to aggregate?
- *Shared parking among tenants:* How does one apply the primary use test in situations where tenants (and perhaps owner as well) share parking and no tenant is allocated any particular number or portion of the parking facility in their leases?

Step 3

Parking reserved for non-employees

- If the primary use of a taxpayer's remaining parking spots is *not* to provide parking to the general public, the taxpayer may
  - Identify the number of reserved non-employee spots
  - Determine the percentage of reserved non-employee spots in relation to the remaining total parking spots and multiply that percentage by the taxpayer's remaining total parking expenses
  - Exclude the resulting product from UBTI

Step 4

Remaining parking expenses

- If the taxpayer has any remaining parking expenses not specifically categorized in Steps 1-3, the taxpayer must reasonably determine the employee use of the remaining parking spots
- Methods may include specifically identifying the number of employee spots based on actual or estimated usage based on
  - Number of spots
  - Number of employees
  - Hours of use
  - Other measures

Post- and pre-tax solutions

- Is charging employees a fair market value price on a "post-tax" basis one way to avoid UBIT?
  - Notice 2018-99 asks whether sale of parking in "bona fide transaction for an adequate and full consideration" could qualify for exception under section 274(e)(8).
  - Does it matter if FMV price is significantly less than the allocable expenses?
- Is it a better solution for the employer and employee to recoup the amount paid in UBIT through increases in pre-tax charges?

Notice 2018-99

Other open questions

- *Joint ventures:* How does one treat qualified parking provided to the employees of joint ventures operating substantially related businesses?
- *Employee parking in foreign branches.* Can expenses for this parking also result in UBTI?
- *Shuttles from satellite parking:* When are they qualified transportation fringes and when are they not?

Estimated taxes on UBTI for QTFs

- Notice 2018-100 waives the addition to tax under section 6655 for a failure to make estimated income tax payments for a tax-exempt organization that meets the following conditions
  - It was not required to file Form 990-T for the tax year preceding its first tax year ending after 12/31/17
    - E.g., 2016 Form 990-T for fiscal year filers and 2017 Form 990-T for calendar year filers
  - Form 990-T for tax year ending 6/30/17
  - The estimated tax was required to be paid on or before 12/17/18
  - The underpayment is attributable to section 512(a)(7)
- To claim the waiver, the tax-exempt organization must timely file its Form 990-T, timely pay the amount reported for the tax year for which relief is granted, and write "Notice 2018-100" on the top of its Form 990-T

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QTF Examples

Example 1

4-step method

Tax-Exempt Organization K is a university and owns numerous surface parking lots adjacent to the buildings on its campus. K incurs $100,000 of total parking expenses. K's parking lots have 5,000 spots that are used by its students, visitors, and employees.
K has 500 spots reserved for executives and faculty and has approximately 1,000 employees parking in the lots in non-reserved spots during the normal operating hours of the university.

— *Step 1.* Because K has 500 reserved spots for employees, $10,000 ((500/5,000) x $100,000 = $10,000) of total parking expenses must be included in UBTI.

— *Step 2.* The primary use of the remainder of K's parking spots are to provide parking to the general public because 78% (3,500/4,500 = 78%) of the remaining spots in the lot are open to the public. Thus, expenses allocable to these parking spots do not have to be included in UBTI.

— *Conclusion:* K will need to include $10,000 in parking expenses in UBTI.

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Example 2

Determining use by the general public

Tax-Exempt Organization J, a religious organization that operates a church and a school, owns a surface parking lot adjacent to its buildings. J incurs $10,000 of total parking expenses. J's parking lot has 500 spots that are used by its congregants, students, visitors, and employees, and 10 spots that are reserved for certain employees. During the normal hours of J's activities on weekdays, J usually has approximately 50 employees parking in the lot in non-reserved spots and approximately 440 non-reserved parking spots that are empty. During the normal hours of J's activities on weekends, J usually has approximately 400 congregants parking in the lot in non-reserved spots and 20 employees parking in the lot in non-reserved spots.

- *Step 1:* Because J has 10 reserved spots for certain employees, $200 ((10/500) x $10,000 = $200) of total parking expenses must be included in UBTI.
- *Step 2.* Because usage of the parking spots varies significantly between days of the week, J uses a reasonable method to determine that the primary use of the remainder of J's parking lot is to provide parking to the general public because 90% (440/490 = 90%) of the spots are used by the public during the weekdays and 95% (470/490) of the spots are used by the public on the weekends. The empty, non-reserved parking spots are treated as provided to the general public. Thus, expenses allocable to these spots do not have to be included in UBTI.
- *Conclusion:* K will need to include $200 in parking expenses in UBTI.

Example 3

Primary use not for the general public

Taxpayer H, a large manufacturer, owns multiple parking lots and garages adjacent to its manufacturing plant, warehouse, and office building at its complex in the city of X. H owns parking lots and garages in other cities as well. For purposes of applying the methodology in this notice, H chooses to aggregate the parking spots in the lots and garages at its complex in city X. However, H may not aggregate the spots in parking lots and garages in other cities with its parking spots in city X. H incurs $50,000 of total parking expenses related to the parking lots and garages at its complex in city X. H's parking lots and garages at its complex in city X have 10,000 spots in total that are used by its visitors and employees. H has 500 spots reserved for management and has approximately 8,000 employees parking in the garages and lots in non-reserved spots during normal business hours on a typical business day at H's complex in city X. Additionally, H has 100 reserved non-employee spots for visitors.

Example 3

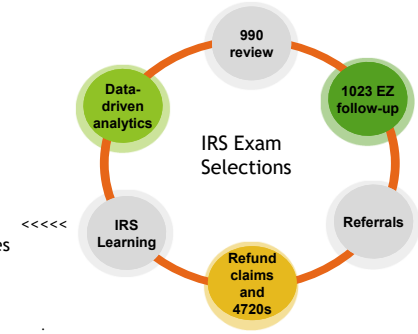
Primary use not for general public (continued)

- *Step 1.* Because H has 500 reserved spots for management, $2,500 ((500/10,000) x $50,000 = $2,500) is the amount of total parking expenses that is nondeductible for reserved employee spots under § 274(a)(4).
- *Step 2.* The primary use of the remainder of H's parking facility is not to provide parking to general public because 84% (8,000/9,500 = 84%) of the remaining parking spots in the facility are used by its employees. Thus, expenses allocable to these spots are not excepted from the § 274(a) disallowance.
- *Step 3.* Because 1% (100/10,000 = 1%) of E's parking lot spots are reserved non-employee spots, the $500 allocable to those spots ($50,000 x 1%)) is not subject to the § 274(a)(4) disallowance and continues to be deductible.
- *Step 4.* H must reasonably determine the employee use of the remaining parking spots during normal business hours on a typical business day and the expenses allocable to employee parking spots at its complex in city X. Because 85.11% (8,000/9,400 = 85.11%) of the remaining parking spots in the lot are used by its employees during normal business hours on a typical business day, H reasonably determines that approximately $40K (($50,000-$3,000) x 85.11%) of H's remaining parking expenses is subject to the § 274(a)(4) disallowance.

Areas of IRS Focus – Update on Recent Exams

Sources of IRS Exam Selection

Initial considerations:



But before notified, IRS does their homework. You may not hear from them.

Strategic issue areas

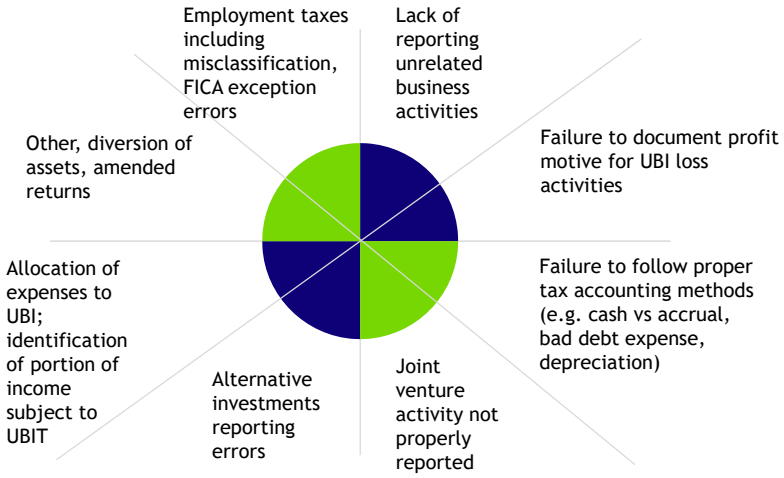
Compliance strategies

<<<<<

Types of IRS exams:
- Correspondence
- Field
- Non-audits

Do what you can up front to reduce chances of being selected for an IRS exam.

Common Exam Issues – Higher Ed



Areas of IRS Examination Interest

- Unrelated Business Income
  - Alternative Investments
  - Space rentals with more than de minimus services (i.e. catering, weddings, private events)
  - Advertising vs. corporate sponsorships
  - General public revenue (i.e. fitness centers, pools, golf course, athletic fields)
- Private Inurement to the benefit of entity disqualified persons (i.e. trustees, officers, their businesses or family members)
- Worker Classification (Employee vs. Independent Contractor)
- Employment Taxes – Misclassification of Employee Benefits (examples - housing, cars, personal expenses, country clubs, family travel, personal drivers, janitorial, personal child/eldercare)
- Significant Diversion of Assets reported on 990
- Tax-Exempt Bond financed buildings and assets (i.e. private business use limits)

Wayfair: The Case and What it Means

Quill – and how we got here

In *Quill v. North Dakota* (1992), the U.S. Supreme Court ruled that a state cannot require a business to collect use tax from in-state customers if the business has no physical presence in the state

— In the 26 years since *Quill* was decided, states have been increasingly aggressive in their efforts to narrow *Quill's* effect and expand what constitutes a physical presence
  - Initial efforts focused on representational nexus – states asserting that the physical presence of a third-party or an affiliate in the state created nexus for the out-of-state seller
  - This required a showing that the in-state person was engaging in activities that were "significantly associated with the seller's ability to establish and maintain a market for sales"

— Most recently, several states have adopted "economic nexus" standards that require sellers with no physical presence to collect sales and use tax if they exceed certain bright-line sales or transaction thresholds
  - Many of these state statutes specifically acknowledged that the economic nexus standards and thresholds conflicted with the Court's holding in *Quill*

South Dakota v. Wayfair

Background

— In 2016, South Dakota passed Senate Bill 106, which adopted an economic nexus standard for sales and use tax purposes
  - Under the revised law, any seller with sales exceeding an annual threshold of $100,000 or 200 separate transactions in South Dakota was required to collect and remit effective May 1, 2016
  - The law was quickly challenged; as was expected

— On September 14, 2017, the South Dakota Supreme Court held that the state is bound to follow established U.S. Supreme Court precedent
  - A law imposing economic nexus standards on remote retailers could not be enforced in light of *Quill*

On January 12, 2018, the U.S. Supreme Court granted certiorari and oral arguments were held April 17, 2018

South Dakota v. Wayfair

On June 21, 2018, the Court ruled in a 5-4 decision in favor of South Dakota

— The Court concluded that the physical presence rule set forth in *Quill* is overruled as it is "unsound and incorrect"

— The physical presence rule "has been the target of criticism over many years from many quarters"

- "*Quill* is flawed on its own terms. First, the physical presence rule is not a necessary interpretation of the requirement that a state tax must be applied to an activity with a substantial nexus with the taxing state. Second, *Quill* creates rather than resolves market distortions. Third, *Quill* imposes the sort of arbitrary, formalistic distinction that the Court's modern Commerce Clause precedents disavow"

— While multistate business may be faced with significant compliance costs, the Court suggested that other aspects of constitutional analysis, can "better and more accurately address any potential burdens on interstate commerce"

— The four dissenters followed varied lines of reasoning, including decrying the lack of a record and that the issue was better left to Congress; none defended the physical presence rule

What are the implications for sellers?

The physical presence rule has been overturned, but it is not clear how the Court's holding will be applied in every other state

— It's important to keep in mind that the Court did not hold that South Dakota's law would be permissible under every circumstance in every state

- The Court held that the taxpayers at issue had the requisite virtual and economic contacts with South Dakota to meet the "substantial nexus" requirement
  - — There might be a different result for different sellers in other states

— Also, under the Court's rationale, the laws, as applied to the sellers, ***cannot discriminate or place undue burdens on interstate commerce***

- The South Dakota statute, in the Court's view, appeared to do neither
  - — The South Dakota law included a safe harbor for those sellers who transacted only limited business in South Dakota; ensured that no obligation to remit the sales tax may be applied retroactively; and, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement

What has happened since Wayfair

Almost all states with a sales tax have now adopted some type of economic nexus standards

— Some have enacted legislation, others have promulgated regulations, and a large number of state revenue departments have simply announced new economic nexus standards (based on broad "doing business" statutes already in place)
  - There has been no legal challenge to a state revenue department creating an economic nexus standard via announcement or guidance
  - The large majority of economic nexus standards mirror South Dakota's, but some differ in important ways (e.g., higher threshold, no transaction threshold, etc.)

— The states that had not adopted anything in 2018 will likely do so in 2019 (many have already)

— Two states, Massachusetts and Ohio, had standards requiring economic nexus plus a software-related presence
  - These standards may be enforced for pre-*Wayfair* periods
  - Both states adopted "pure" economic nexus provisions in 2019

Reactions to *Wayfair* – 8/8/2019

A. Economic nexus with effective date					
Effective Prior to 1/1/2019			Effective 1/1/2019	Effective After 1/1/2019	
AL – 10/1/2018	MD – 10/1/2018	NY – 6/21/2018[1]	DC – 1/1/2019	AR – 7/1/2019	NM – 7/1/2019
CT – 12/1/2018	MI – 10/1/2018	NV – 10/1/2018	IA – 1/1/2019	AZ – 10/1/2019	OH – 8/1/2019[4]
HI – 7/1/2018	MN – 10/1/2018	SC – 11/1/2018	NE – 1/1/2019	CA – 4/1/2019	OK – 11/1/2019
IL – 10/1/2018	MS – 9/1/2018	SD – 11/1/2018	UT – 1/1/2019	CO– 6/1/2019[2]	PA – 7/1/2019
IN – 10/1/2018	NJ – 11/1/2018	VT – 7/1/2018	WV – 1/1/2019	GA – 1/1/2020	RI – 7/1/2019
KY – 10/1/2018	NC – 11/1/2018	WA – 10/1/2018		ID – 6/1/2019	TN – 10/1/2019
ME – 7/1/2018	ND – 10/1/2018	WI – 10/1/2018		KS – 10/1/2019	TX – 10/1/2019
				LA – TBD	VA – 7/1/2019
				MA – 10/1/2019[3]	WY – 2/1/2019
B. Other					
FL	MO	PR (report)			

[1] New York guidance -- issued 1.15.2019 -- indicated that existing statutory thresholds became effective "immediately" after *Wayfair* (6.21.2018) and vendors meeting the thresholds should register "immediately."

[2] Colorado's economic nexus rule was to go into effect December 1, 2018, but the Department announced a grace period through May 31, 2019.

[3] Effective October 1, 2017, Massachusetts' $500,000 and 100 transaction economic nexus threshold applied to retailers with software or content distribution networks in the state. Effective October 1, 2019, the economic nexus threshold applies to all retailers without a physical presence in Massachusetts.

[4] Effective January 1, 2018, Ohio's $500,000 economic nexus threshold applied to retailers with software or content distribution networks in the state. Effective August 1, 2019, the economic nexus threshold applies to all retailers without a physical presence in Ohio.

Economic nexus
As of August 8, 2019

State	Threshold	Effective Date
Alabama	Over $250,000	October 1, 2018
Arizona	Over $200,000 (calendar year 2019) Over $150,000 (calendar year 2020) Over $100,000 (calendar year 2021 and after)	October 1, 2019
Arkansas	Over $100,000 or 200 transactions	July 1, 2019
California	Over $500,000	April 1, 2019
Colorado	Over $100,000	June 1, 2019 (grace period from December 1, 2018)
Connecticut	$100,000 and 200 transactions	December 1, 2018
District of Columbia	Over $100,000 or 200 transactions	January 1, 2019
Georgia	Over $100,000 or 200 transactions	January 1, 2020
Hawaii	$100,000 or 200 transactions	July 1, 2018

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Economic nexus, continued
As of August 8, 2019

State	Threshold	Effective Date
Idaho	Over $100,000	June 1, 2019
Illinois	$100,000 or 200 transactions	October 1, 2018
Indiana	Over $100,000 or 200 transactions	October 1, 2018
Iowa	$100,000 or more	January 1, 2019
Kansas	Not specified	October 1, 2019
Kentucky	Over $100,000 or 200 transactions	October 1, 2018
Louisiana	Over $100,000 or 200 transactions	TBD
Maine	Over $100,000 or 200 transactions	July 1, 2018
Maryland	Over $100,000 or 200 transactions	October 1, 2018 (effective date of emergency regulation)

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Economic nexus, continued

As of August 8, 2019

State	Threshold	Effective Date
Massachusetts	Over $100,000	October 1, 2019*
Michigan	Over $100,000 or 200 transactions	October 1, 2018
Minnesota	Regular or systematic solicitation of sales, plus over $100,000 or 200 or more transactions	October 1, 2018
Mississippi	Over $250,000 plus purposeful or systematic exploitation of the Mississippi market	September 1, 2018
Nebraska	Over $100,000 or 200 transactions, plus meet "doing business" definition	January 1, 2019
Nevada	Over $100,000 or 200 transactions	October 1, 2018
New Jersey	Over $100,000 or 200 transactions	November 1, 2018
New Mexico	$100,000	July 1, 2019
New York	Over $500,000 **and** 100 transactions	June 21, 2018**

* Effective October 1, 2017, Massachusetts' $500,000 and 100 transaction economic nexus threshold applied to retailers with software or content distribution networks in the state. Effective October 1, 2019, the economic nexus threshold applies to all retailers without a physical presence in Massachusetts.
** New York guidance -- issued 1.15.2019 -- indicated that existing statutory thresholds became effective "immediately" after *Wayfair* (6.21.2018) and vendors meeting the thresholds should register "immediately."

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Economic nexus, continued

As of August 8, 2019

State	Threshold	Effective Date
North Carolina	Over $100,000 or 200 transactions	November 1, 2018
North Dakota	Over $100,000	October 1, 2018
Ohio	Over $100,000 or 200 transactions	August 1, 2019*
Oklahoma	$100,000	November 1, 2019
Pennsylvania	$100,000	July 1, 2019
Rhode Island	$100,000 or 200 transactions	July 1, 2019
South Carolina	Over $100,000	November 1, 2018
South Dakota	Over $100,000 or 200 transactions	November 1, 2018
Tennessee	Over $500,000 **and** regular or systematic solicitation	October 1, 2019

* Effective January 1, 2018, Ohio's $500,000 economic nexus threshold applied to retailers with software or content distribution networks in state. Effective August 1, 2019, the economic nexus threshold applies to all retailers without a physical presence in Ohio.

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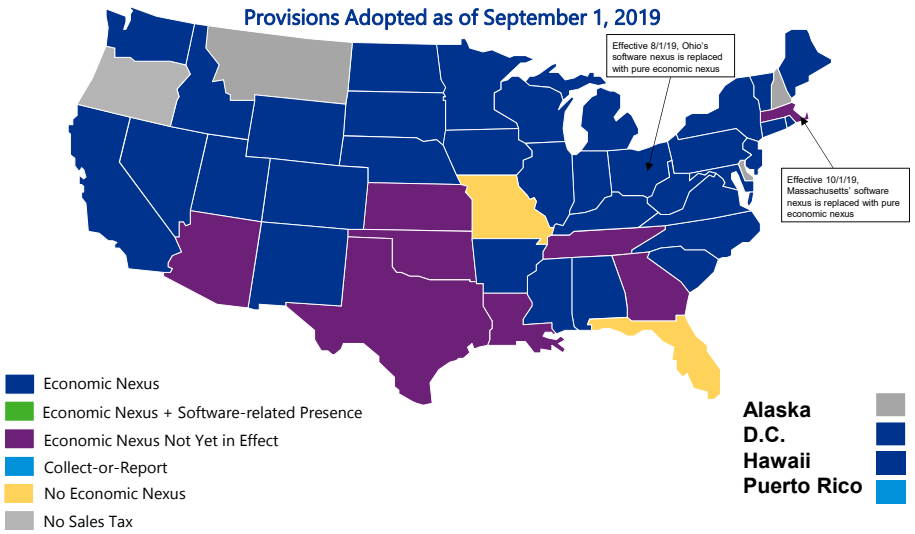
Economic nexus, continued

As of August 8, 2019

State	Threshold	Effective Date
Texas	Over $500,000 **and** solicitation for taxable items	October 1, 2019
Utah	Over $100,000 or 200 transactions	January 1, 2019
Vermont	Regular, systematic, or seasonal solicitation of sales, plus either $100,000 or 200 transactions	July 1, 2018
Virginia	Over $100,000 or 200 transactions	July 1, 2019
Washington	Over $100,000	October 1, 2018
West Virginia	Over $100,000 or 200 transactions	January 1, 2019
Wisconsin	Over $100,000 or 200 transactions	October 1, 2018
Wyoming	Over $100,000 or 200 transactions	February 1, 2019

Economic nexus



Issues – remote sellers generally

Besides having to register and collect in new states, what are the other issues?

- Determining taxability of goods in new states where the seller has a collection obligation
  - Not always easy- even when selling tangible personal property
    - A number of states have exemptions for clothing, periodicals, etc.
    - Determining what does and does not fall within the scope of an exemption may not be simple and will be subject to audit
  - Does the state have sales tax holidays that need to be addressed for online sales?
  - Does the seller have a process for collecting and storing exemption certificates for sales to exempt organizations?
- Determining the tax base upon which sales tax is charged
  - Are delivery/shipping costs subject to sales tax in each state?
  - Are there ancillary services being provided as part of the sale that would be taxable under a true-object analysis?

Wayfair implications for colleges and universities

Colleges and universities will need to evaluate where they have nexus and a filing requirement

State *Wayfair* nexus standards typically look at the volume of transactions in a state regardless of whether those transactions are taxable

- For example, receiving 200 individual application fees from a state can now create a sales tax filing requirement in a state
- Some states require sales tax returns to be filed even if there is no tax to be remitted

Oftentimes, when institutions analyze their nexus footprint, they discover that they may have had physical presence nexus in states arising from before the *Wayfair* decision. For colleges and universities this may include (but is not limited to):

- Athletic team travel and recruiting
- Academic recruiting
- Employee travel

What is a tax-exempt educational institution for sales tax purposes?

How tax-exempt organizations are defined, and the exemptions provided for sales/use taxes (if any), vary by state

— Some states publish a list of entities within their statute/law

— Some states require periodic renewal of exemption certificate, once issued

— May be limited to specific types of tax-exempt organizations, depending on their purpose, for example:

- Organizations qualifying under a particular IRC section (e.g., 501)
- Religious organizations
- Educational institutions
- Eleemosynary / charitable institutions
- Various types of hospitals

— Exemptions for purchases vs. sales by a tax-exempt organization vary by state

Purchases made by tax-exempt educational institutions

Approximately 40 states provide some kind of sales/use tax exemption for purchases made by qualifying tax-exempt organizations

— Must be for use in the organization's tax-exempt purpose

— Purchases must generally be made directly by the organization (e.g., not with an employee's personal funds for reimbursement)

A handful of states do not provide a broad entity-level exemption, but may provide limited exemptions for certain purchases

— Washington State provides an exemption for certain sales to health or social welfare organizations of items necessary for new construction of alternative housing for youth in crisis. As such, colleges and universities in Washington are subject to sales tax on the majority of their purchases.

Sales made by tax-exempt educational institutions

Though not as common as exemptions for *purchases*, several states provide exemptions for sales made by tax-exempt organizations

— The scope of such an exemption varies by state

- **Examples of broad exemptions for sales made by exempt organizations**
  - — Missouri exempts all sales made by or to religious and charitable organizations and institutions in their religious, charitable or educational functions and activities
  - — Nevada exempts the sale of tangible personal property sold by or to a nonprofit organization created for religious, charitable or educational purposes
- **Examples of exemptions for sales at specific events**
  - — Connecticut exempts the sale of tangible personal property by nonprofit organizations at a limited number of bazaars, fairs, picnics, tag sales, or similar events
  - — Minnesota exempts sales by specified organizations for fundraising purposes (only applies to the first $20,000 of gross annual receipts from fundraising)

Wayfair implications for foreign educational institutions

Wayfair did not distinguish between foreign sellers and domestic sellers

— Treaty protections generally do not apply to state indirect taxes

— Unless a state adopts a specific carve-out for non-U.S. sellers, it is expected that states will likely apply economic nexus standards to both domestic and foreign sellers

A foreign seller's specific fact pattern may create unique issues

— Foreign sellers may be able to argue that these laws, as applied to them, discriminate or are unduly burdensome

— Questions may arise as to how states may enforce these laws against a company with no presence in the state (or in the country)

Other potential areas of concern

Post-_Wayfair_, more out-of-state vendors may now begin charging tax, so invoices will need to be scrutinized more closely

— Colleges and universities may now need to register in additional states to obtain state-specific exemption certificates

— Consider self-assessment of use tax on items purchased for giveaway if not covered by an exemption in the state where the items are given away

— Consider self-assessment of use tax on direct mail in states where direct mail is subject to sales tax and educational institutions are not exempt from sales tax

Colleges and universities should examine their volume of sales to out-of-state customers and confirm the taxability of products/services sold, such as:

— Book store and technology sales

— Online training / educational courses (*e.g.,* online CLE and CME)

— Periodicals (digital or printed)

— Sales of donated and obsolete items

Relationships with third parties

Unique considerations may arise from certain relationships with third parties

— Online store run by a third party

— Orders fulfilled by a third party warehouser or merchandiser

Potential post-*Wayfair* considerations

— Impact of economic nexus standards may depend on which party is considered the retailer of the products sold

- Which party counts the sales and transactions toward their economic nexus threshold?
- Which party is required to collect tax on the sales?

— Some states have broad definitions of marketplace facilitator that could capture more than traditional online marketplace platforms

Income tax consequences

The repeal of the *Quill* physical presence standard has state unrelated business income tax (UBIT) implications, as well

— Although many states assert economic nexus for corporate income tax / UBIT purposes, not all states have specific or bright-line economic nexus authority

— Six states have re-evaluated their economic nexus position with regards to income taxes in light of the overturn of *Quill* and additional states are sure to follow.

Steps to consider

— To the extent *Quill* was relied on for a non-filing position, that should likely be re-evaluated and nexus documentation updated

— Reserves may need to be increased in jurisdictions with pre-*Wayfair* economic nexus position if entity is not fully reserved

— Consider the impact of registering for sales/use tax on possibility of nexus questionnaire or other income tax inquiry by state

— Consider possible pursuit of a VDA if non-filing position is questionable

— Monitor state announcements carefully

Income tax consequences – cont'd

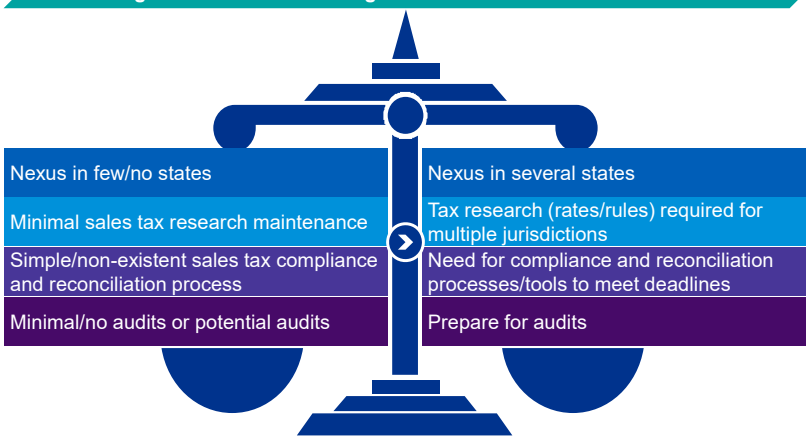
State taxing authority registration requirements to consider

- Several states have specific forms for establishing state-level tax-exempt organization status for income/franchise tax purposes
  - California Form FTB 3500
  - Montana Form EXPT
  - New York Form CT-247
  - Utah Form TC-161
  - Texas (varies, depending on type – Form AP-204, Form AP-205, etc.)
- Several other jurisdictions may require that a copy of the organization's IRS exemption letter or other proof of federal tax-exempt status be sent to the state or local taxing authority
  - Examples: Louisiana, New York City, North Carolina

Next steps

Infrastructure needs change overnight!

Quick change in rules = Quick change in infrastructure needs for sales tax



"Zero to Prepared" immediately

Navigating a world without *Quill*

Step 1 – Review Existing and Post-*Wayfair* Nexus Footprint
- Existing filing obligations – consider VDA/amnesty programs
- Assess post-*Quill* filing obligations

Step 2 – Consider the Overall Business Implications
- Communicate with all stakeholders in the organization
- Involve legal, marketing, supply chain, technology, direct tax, finance

Step 3 – Review Product/Service Mix
- Develop taxability determinations
- Examine bundled items

Step 4 – Review and Consider Technology Needs
- What do you have and what are your options?
- Consider tax engine upgrades or outsourcing compliance processes

Step 5 – Filing Compliance and Initial Registration
- Register in new jurisdictions
- Ensure that all returns and remittances are timely filed

Step 6– Monitor Tax Updates and Handle State Audits
- Stay abreast of tax updates (nexus, rates, exemptions, etc.)
- Prepare for increased audit activity with new jurisdictions

Post-*Quill* readiness checklist

Issue		Action
Has your organization reviewed its existing and Post-*Wayfair* nexus footprint?	NO	— Nexus Impact Review — VDA and Business Registration
YES		
Has your organization considered the overall business implications of *Quill* being overturned?	NO	— Business Strategy Roadmap — Tax Transformation & Business Change Management — Potential ASC 450 Impact
YES		
Has your organization reviewed its product / service mix in each new jurisdiction to determine taxability?	NO	— Taxability Review — Product Mapping
YES		
Has your organization evaluated its technology needs now that *Quill* has been overturned?	NO	— Diagnostic Review — Software Selection — Tax Engine Implementation
YES		
Does your organization's compliance team have the capacity to register in new jurisdictions, file all necessary returns, and maintain exemption certificates?	NO	— Indirect Tax Compliance Service — Exemption Certificate Support Service — Business License Registration Service
YES		
Is your organization able to monitor tax updates and handle increased state audits?	NO	— Updates on tax legislation and changes — Audit support and controversy

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Benefits of using technology/automation

Operational Efficiency

— Time Savings
— Cost savings e.g., training, research
— Easier to manage overseas compliance and localization issues
— Eliminate manual processes
— Reduce reliance on IT for reports
— Ease of managing big data

Business Enablement

— Better tools to manage complex transactions
— Greater flexibility and control to adapt to business changes
— Geographic expansion
— Regulatory changes
— Product line expansion
— Merger/Acquisitions

Risk Management

— Ease of embedding controls
— Better and centralized management of tax decisions/treatments
— SOX and security controls
— Enhanced audit trail

Planning

— Better control and insight of data
— Enhanced management reporting capabilities
— Tools to easily work with/model tax data
— Time freed up for strategic decisions and value add activities

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Voluntary disclosure agreements (VDAs)

VDAs are a means to mitigate tax exposure in a given state, particularly if nexus has existed for multiple years

- VDA program benefits include:
  - Limited look-back period;
  - Waiver of penalties;
  - In some cases, reduced interest; and
  - A means to "close" prior tax years
- Process typically involves using a third party service provider (e.g., KPMG) to make contact with the state revenue authority on an anonymous basis and help negotiate an agreement
- Once agreement terms are finalized, the organization identifies itself and submits the applicable returns and/or registration form and files prospectively for as long as nexus exists

Contacts

Contacts

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