

Spring Business Tax Seminar  
May 25, 2011

# Multistate Taxation

Presented by:  
Mark G. Janulewicz, CPA  
Partner



## State Budget Deficits

- California - \$25.4 Billion
- Texas - \$13.4 Billion
- New Jersey - \$10.5 Billion
- New York - \$10 Billion
- Illinois - \$4.9 Billion
- Pennsylvania - \$4.2 Billion
- Florida - \$3.6 Billion
- Ohio - \$3.0 Billion
- Total for all states and D.C. - \$111.9 Billion



## Multistate Taxes

- A corporation doing business in more than one state must determine which states it is subject to taxes and filings in.
- Nexus is a sufficient presence within the state to allow the state to have taxing authority.



3

## State Income Tax

- There are two types of nexus standards for state income tax.
- A physical presence nexus standard – defined as employees, property (rented or owned) or inventory within a state.
- Economic nexus standard – does not consider employees or property but instead looks at the economic substance or business purpose. Also is called a “Market” approach.

4

## Public Law 86-272



- The federal government, in an effort to protect out of state sellers of tangible personal property, enacted Public Law 86-272.
- Requires some form of a physical presence in a state to subject a foreign corporation to its corporate income tax.

5

## Public Law 86-272 (con't)

- P.L. 86-272 prohibits a state from taxing the income of a foreign corporation if the corporation's only in state activity is:
  1. Solicitation of orders.
  2. Sale of tangible personal property.
  3. Orders are approved outside the state.
  4. Orders are shipped from outside the state.

6

## Limitations on P.L. 86-272

- Only applies to income tax (no protection from franchise tax or sales tax).
- Several states don't impose an income tax so P.L. 86-272 is not applicable.
- If any services are sold or provided and if any intangibles are sold then P.L. 86-272 is not applicable.

7

## Physical Presence Standard

- Compensation paid to employees in a state could potentially cause a company to have nexus in that state. Review company records to determine where payroll is being paid. State taxing authorities can cross reference payroll returns with income tax returns.
- Owning or renting property in a state will generally cause a company to have nexus in that state. This includes real property, personal property or inventory.

8

## Economic Nexus

- Some states have moved away from requiring a physical presence for business activities taxes.
- States to consider:  
California, Colorado, Connecticut, Michigan, Ohio, Texas and Washington



9

## CALIFORNIA



- California implemented an economic nexus standard as of 1/1/11.
- If California sales are over \$500,000 or 25% of the taxpayer's total sales, the corporation has franchise tax nexus.
- California still recognizes P.L. 86-272. If a corporation has economic nexus but falls within P.L. 86-272 then they would file the California franchise tax return. The corporation would be subject to the minimum tax & disclose on the return that they are protected under P.L. 86-272.

10

## Colorado



- Colorado implemented an economic nexus standard as of 4/30/10.
- Whenever the minimum standards of P.L. 86-272 are exceeded and sales to Colorado customers are \$500,000 or more or 25% of sales are to Colorado customers a corporation has economic nexus.
- Colorado recognizes P.L. 86-272 and does not require a corporation protected under P.L. 86-272 to file a return.

11

## Connecticut



- Connecticut implemented an economic nexus standard as of 1/1/10.
- If sales to Connecticut customers are \$500,000 or more then the corporation has income tax nexus.
- Connecticut still offers protection under P.L. 86-272. Corporations protected would still be subject to the capital base tax and would file the CT-1120 and claim exemption from the income tax.

12

## Michigan



- Michigan Business Tax (MTB) was introduced in 2008.
- MBT has two components - a gross receipts tax and an income tax. P.L. 86-272 provides protection against the income tax component.
- Michigan has two nexus standards to consider.

13

## Michigan *(con't)*



- The first is a physical presence standard which states that if a company has a physical presence within the state for more than one day in a tax year, they are considered to have nexus.
- The second standard is a form of an economic nexus standard. If a corporation has \$350,000 or more of sales to Michigan customers and “actively solicits” sales in Michigan then they have nexus. Active solicitation is defined as telephone calls, emails or mail to current or prospective clients.

14

## Ohio



- Ohio Commercial Activity Tax (CAT) is a gross receipts tax with a low tax rate.
- Ohio implemented the CAT tax in 2005.
- A taxpayer has substantial nexus for CAT if either of the following situations exists:
  - If the corporation has over \$500,000 or more of Ohio sales or
  - If a corporation has an employee or property in Ohio and has \$150,000 or more in sales.

15

## Texas



- Texas Franchise Tax is not an income tax and does not recognize P.L. 86-272. Texas uses a gross margin tax.
- An entity establishes nexus in the state by having employees, independent contractors, agents or other representatives enter the state to solicit. Even if the employees or agents reside outside the state, entering the state to solicit creates nexus.

16

## Washington



- Washington B&O Tax is based on economic nexus standard. The B&O tax is a gross receipts tax with a low tax rate.
- Washington implemented the nexus standard on June 1, 2010.
- Sales of over \$250,000 to Washington customers creates nexus.

17

## Sales Tax General Information

### Overview of sales tax nexus –

- Employees within a state, even if it is only sales people, creates nexus. Many times independent representatives can create sales tax nexus as well.
- Attribution/ Affiliated nexus can be created through the use of related companies.
- No protection under P.L. 86-272.
- Attending trade shows can create nexus depending on the state and the frequency.

18

## New Developments in Sales Tax

- NY, NC & RI have enacted laws stating their sales tax nexus policy with respect to on line vendors.
- Amazon-law or click thru nexus.



19

## New Developments in Sales Tax *(con't)*

- This requires an internet retailer to collect and remit sales taxes based on the idea of “click-thru nexus”. An out of state online retailer has nexus with NY if it enters into an agreement with a New York resident to refer customers to the online retailer’s website for a commission.



20

## Managing Multistate Tax Exposure

**If you determine that you may have nexus in various states, you have several options that should be discussed with your tax advisor:**

- Determine the exposure to sales, payroll and income taxes.
- Register with the state taxing authorities and file all back tax returns.
- Wait until the state finds your business. Consider the downside of not filing.
- Consider Voluntary Disclosure or Amnesty Programs.

21

## Voluntary Disclosure

**Programs are designed to promote compliance and to have taxpayers start paying taxes at a certain point in time with some safeguards.**

- Allows taxpayers to limit the look back period.
- Allows, in certain cases, simplified reporting.
- Waiver of penalties and criminal charges.
- But, the programs generally do not apply to companies that have already been contacted or who are already registered with the state.

22

## States are More Aggressive

- Common message at the seminar was that the states are all desperate for taxes.
- States don't want to raise the tax rate.
- They are looking to increase the amount of corporations subject to their taxes.

23

## States are More Aggressive *(con't)*

- Penalties are a large revenue raiser for the states and many states have incorporated mandatory penalties provisions to raise money.
- Now it is more important than ever – to look over potential state tax filings and exposure.

24

## Circular 230 Disclosure

---

---

In accordance with Internal Revenue Service Circular 230, please be advised that unless otherwise expressly stated, any discussion of a federal tax issue in this communication or any attachments to this communication is not intended to be used, and it cannot be used, for the purpose of avoiding tax penalties that may be imposed on any taxpayer.

25

Spring Business Tax Seminar  
May 25, 2011

---

---

## Multistate Taxation

Mark G. Janulewicz, CPA  
mjanulewicz@lumsdencpa.com



Spring Business Tax Seminar  
May 25, 2011

## **ALWAYS VIGILANT**

Creating An Effective Antifraud Environment

Presented by:  
Douglas P. Sosnowski, CPA/ABV, ASA, CVA, CFF  
Principal



### **Agenda**

- Ethics Awareness
- Consequences of Fraud
- Types of Fraud & Abuse
  - Organizational Profile
- Common Fraudulent Schemes
- How to Detect Fraud
  - Red Flags
  - Recurring themes
  - Fraud Cycle
- How to Prevent Fraud
- Creating an Effective Anti-Fraud Environment

2

## Ethics Awareness

---

An effective antifraud environment requires a culture with a strong value system founded on integrity.

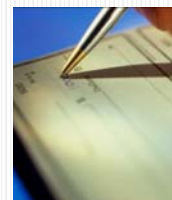
- Employees will follow your lead
- Every company has a “corporate culture”
- Tone at the top

3

## Consequences of Fraud

---

- Loss of Reputation
- Higher Cost of Capital
- Loss of Assets
- Inability to Attract the Most Qualified Workforce
- Reduced Value of Investment to Stakeholders
- Criminal and Civil Proceedings Against the Organization



4

## Fraud Statistics

- Fraud and abuse costs U.S. organizations more than \$650 billion annually
- The average organization loses about 5% of its total annual revenue to fraud and abuse
- Executives account for 20% of cases
- One third of the American workforce steals money or merchandise from their employer



5

## Fraud Statistics

- The most costly abuses occur in organizations with less than 100 employees
- The typical perpetrator is a college-educated white male
- Organizations without confidential reporting mechanisms experienced losses that were 2x as high as those with established, anonymous reporting

6

## Fraud Can Occur At Any Organization

- Most perpetrators would not commit other types of crimes and are first-time offenders
- Most intend to correct fraud (e.g., repay the money) after they resolve their pressure
- Perpetrators usually do not see themselves as criminals
- Common victim response: “I can’t believe he would do this! He was my most trusted employee.”
- Most culprits have a plan that includes a conclusion and resumption of normal activity

7

## Rationalizations to Commit Fraud

Rationalization occurs when the individual develops a justification for fraudulent activities. The rationalization varies by case and individual. Some examples include:

- **Everyone’s doing it...**
- **I will pay it back...**
- **It’s a big company – they won’t miss it...**
- **I really need this money and I’ll put it back when I get my paycheck**
- **I’d rather have the company on my back than the IRS**
- **I just can’t afford to lose my home, car, everything**
- **I need to make my number for this Quarter.....**

8

## Types of Crimes Against Organizations

---

- Bribery, Kickbacks & Corruption (30.8 %)
- Financial Statement Fraud (10.6%)
- Embezzlement (91.5%)

9

## Embezzlement Defined

---

- Embezzlement is the act of dishonestly appropriating goods, usually money, by one to whom they have been entrusted.
- Embezzlement sometimes involves falsification of records in order to conceal the theft. Schemes can continue for many years before being detected depending on the skill of the embezzler in concealing the nature of the transactions.
- Embezzlers commonly steal relatively small amounts repeatedly over a long period, although some embezzlers steal one large sum at once.

10

## Common Fraudulent Schemes

### Procure-to-Pay

- Management disburses funds to fictitious entity and diverts funds for personal use
- Management inserts dummy entity between a legitimate supplier and the company and diverts the mark-up to personal account
- Fraudulent invoices
- Payment for goods not received
- Vendor kick-backs

11

## Common Fraudulent Schemes

### Payroll Schemes

#### Ghost Employees

- Someone on the Payroll who doesn't actually work for the victim organization
- Candidates
  - Dead Persons
  - Fictitious Names
  - Departed Employees
  - Friends of the culprit
- Scheme benefits from an accomplice, but does not require one

12

## Common Fraudulent Schemes

### Payroll Schemes

#### Falsified Hours and Expenses

- Dishonest employees commonly exaggerate to increase their compensation
- Payroll clerks, familiar with internal controls, sometimes adjust their own salaries
- May involve a supervisor as an accomplice, who can share in the extra money and provide authorization or approval
- Expense reimbursements can be easily fabricated, overstated, or supported by false documentation

13

## Common Fraudulent Schemes

### Payroll Schemes

#### Commission Manipulation

- For sales personnel who are compensated based upon sales, the trick is to increase either
  - Number of Sales Transactions
  - Amount/Value of Sale
  - Commission Rate
- Channel Stuffing - A related financial statement fraud involving improper revenue recognition

14

## Common Fraudulent Schemes

---

### Improper Revenue Recognition

- Simple
  - Bill and hold
  - Fictitious sales
- Complex
  - Software revenue recognition
  - Increased complexities of accounting models follow increased complexity of transactions

15

## Common Fraudulent Schemes

---

### Improper Revenue Recognition

- Manipulation of Accounting Estimates
  - Cookie jar reserves
    - Accounts receivable
    - Bonus reserves
    - Obsolescence reserves
    - Warranty accruals
    - Loss contingency reserves
  - Asset impairment evaluations

16

## How to Detect Fraud

### How is MOST financial statement fraud detected?

- A. By the Company's external auditors during quarterly reviews or annual audits
- B. By the Company's internal auditors during their audit procedures
- C. By tips provided by employees
- D. By the Securities & Exchange Commission

17

## How to Detect Fraud

### Auditors' Responsibility

Under U.S. generally accepted auditing standards (GAAS), auditors are responsible for planning and performing an audit to obtain *reasonable assurance* the financial statements are free of material misstatement, whether caused by error or fraud.



18

## How to Detect Fraud

---

---

### How Frauds Are Typically Uncovered

- Anonymous Tips – 40% (60% employees, 20% customer, 16% vendors)
- Internal Audits – 24%
- Accidentally – 21%
- Internal Controls – 18.5%
- External Audits – 11%

19

## How to Detect Fraud

---

---

- Get Lucky
- Third-Party Anonymous / Fraud Hotline/ Whistle Blower Program (most effective)
- Surprise Audit
  - SAS 99 (external auditor)
  - Internal Audit Department
- Data Analysis (vertical & horizontal)

20

## How to Detect Fraud

---

---

### Red Flags

- Significant topside adjustments
- Transactions recorded late
- Unusually complex transactions
- Unsupported or unauthorized transactions
- Frequent correcting entries
- Unreasonable explanations for variations in reported results

21

## How to Detect Fraud

---

---

### Red Flags

- Employees who do not take vacations
- Employees with no benefits and no reviews, promotions, raises
- Unusual level of involvement in lower level activities by a higher ranking employee
- Employee request for mail not to be opened or to be immediately delivered to his desk
- Change to master file followed by unusual activity

22

## How to Detect Fraud

---

### Data Analysis

- Reconcile general ledger activity to trial balances
- Compare the outstanding check list to bank statements
- Analyze A/R credits per customer
- Analyze vendors and costs

23

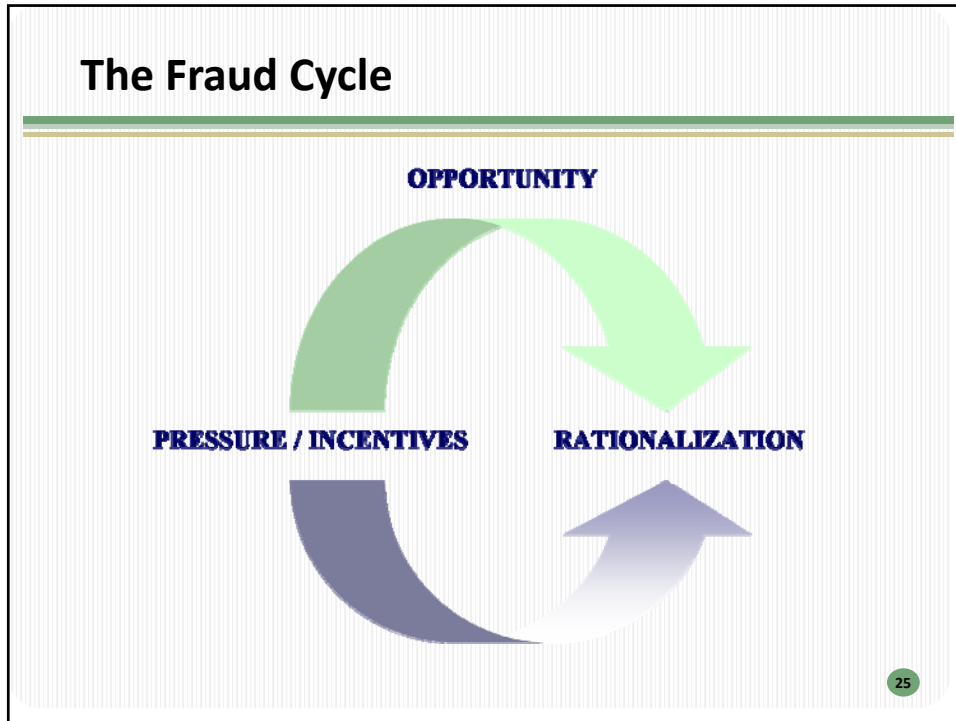
## How to Detect Fraud

---

### Data Analysis

- Identify patterns of fraud
  - Vendors consistently at or just below signatory limit
  - Payment of duplicate invoices
  - Round dollar transactions
  - Ghost employee analysis, including SSN comparison
- Conduct trend analysis
  - Change in vendors/amount spent with vendors over time
- Identify data anomalies
  - Manual journal entries made after 11:00 pm or on holidays

24



## The Fraud Cycle

### Pressures to Commit Fraud

#### Financial

- Greed
- Living beyond one's means and high personal debt
- High medical bills, personal financial losses and unexpected financial needs
- Poor credit

#### Vices

- Gambling
- Drug or alcohol abuse
- Expensive extra-marital relationships

A small green circle with the number 26 is located in the bottom right corner of the slide.

## The Fraud Cycle

---

### Opportunities to Commit Fraud

- Poor job applicant screening procedures
- Inadequate physical security and record keeping for susceptible assets
- Lack of segregation of duties
- Lack of checks and balances
- Lack of independent authorization and approvals
- Lack of timely/appropriate documentation
- Lack of a mandatory vacation policy

27

## The Fraud Cycle

---

### Opportunities to Commit Fraud

- Poor record-keeping practices
- No oversight by management
- Lack of fraud awareness training within the organization
- Lack of an effective investigative due diligence process for employees and vendors

28

## How to Prevent Fraud

---

---

- Effective Board/Audit Committee Oversight
- Organizational Structures, Policies and Procedures
- Ethics Awareness and Education
- Fraud Education
- Mechanisms for Reporting, Investigating and Remediating Fraud
- Background Investigations and Employment Practices
- Monitoring of Anti-Fraud Programs and Controls

29

## How to Prevent Fraud

---

---

- Provide means for anonymous tips from anywhere
- Minimize employee access to manual checks
- Reconcile bank statements when they arrive
- Look for gaps in check numbers or out-of-sequence items
- Look for perforated edges on the checks, changes in background colors or other changes to check stock
- Notice potential culprits who are overly polite, nervous, or aggressive and hurried

30

## How to Prevent Fraud

### Segregation of Duties

- A fundamental anti-fraud control
- Increases the probability that errors or irregularities are prevented or detected on a timely basis by employees in the normal course of business.
- Where duties cannot be fully segregated, mitigating or compensating controls must be established.



31

## How to Prevent Fraud

- The risk of management override or collusion exists at every organization
- How can the Board and Audit Committee oversee the actions of management?
  - Maintain skepticism
  - Strengthen Board understanding of the business
  - Brainstorm to identify fraud risks
  - Use Code of Conduct to assess financial reporting culture
  - Vigorous whistleblower program
  - Develop a broad information and feedback network

32

## The Antifraud Environment

---

---

**Awareness**

**Detection**

**Prevention**

**Be Vigilant at all times**

33

Spring Business Tax Seminar  
May 25, 2011

---

---

Douglas P. Sosnowski, CPA/ABV, ASA, CVA, CFF



dsosnowski@briscon.com  
716-270-4954