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## ***American State and Local Taxes: Trends and Developments***

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Israeli businesses are effective vendors of goods and services, and export some \$7 billion of goods and services to the United States annually. However, while mid-sized Israeli businesses (defined here as those having annual U.S. revenues of between \$3 million and \$50 million) commonly plan for taxes enforced by the Internal Revenue Service and covered by the treaty between Israel and the United States, many do not plan for state taxes. The consequences of noncompliance with state tax obligations can be severe. Therefore, this article updates the Hebrew and English state tax materials available at [www.statetaxalert.us](http://www.statetaxalert.us) by discussing the following trends and developments:

- The states' efforts to obtain jurisdiction over remote businesses,
- Tax issues raised by a popular new business model,
- Punishments imposed by the United States Securities and Exchange Commission for noncompliance with state tax laws, and
- Personal responsibility for corporate officers and other persons for a business's unpaid state taxes

*Reminder: States can impose taxes even if the United States government cannot. This is because the Israel-US tax treaty does not apply to the states. In addition, the states can impose taxes even if a business's only presence in the state is through a traveling sales person – or even through a non-employee representative or an interest in property temporarily located in the state. This is a much lower threshold than the “permanent establishment” generally required to support federal taxation of a foreign business.<sup>2</sup>*

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<sup>2</sup> See “Doing Business in the U.S.” at [www.statetaxalert.us](http://www.statetaxalert.us).



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## **States' Efforts to Reach Remote Vendors – Sales and Use Taxes**

Under current law, a state cannot require a business to collect its sales and use taxes unless the business has some physical presence in the state.<sup>3</sup> However, in an effort to reach remote Internet vendors, many states<sup>4</sup> have enacted laws asserting tax jurisdiction over businesses placing links on the web sites of organizations having tax presence in the states. This is referred to as “click-through nexus”, and in some instances it applies to mail order businesses as well as Internet sellers. It has been upheld by New York’s courts, and is the leading trend in state taxation.

With sales taxes imposed by 45 states and thousands of local jurisdictions at rates of 7-10% of retail sales price, few businesses are willing to accept the risk that they will be liable for their customers’ tax. Instead, most businesses are responding to click-through nexus by reducing their exposure for uncollected taxes. Such reductions can be accomplished in one of two ways: either by registering the business for collecting sales taxes, or by changing the business’s method of operation to avoid click-through nexus.

Israeli businesses are vulnerable to this theory of extended jurisdiction, as many operate through a remote sales structure. However, because of lack of familiarity with state taxation, it appears that many Israeli retailers are not collecting state sales or use taxes. This error can create a large exposure for the business and personal liability for its officers and others who are responsible for the business’s tax compliance. See below for more on responsible personal liability.

More troubling is the “self help” approach of collecting estimated sales taxes but holding the collected taxes as protection in the event of an audit. This is a crime in every state and punished by state revenue departments and attorneys general. A business that engages in such activity should stop doing so, and should take other protective measures. Furthermore, the remittance of any improperly collected taxes is a delicate process that must be handled through experienced state tax legal counsel.<sup>5</sup>

## **Prepaid Discount Vouchers (“Groupon”) Sales Approaches**

Sales of prepaid discount vouchers have taken United States retailers by storm, with Groupon being the most prominent organizer of these discount programs. These programs involve a website promoting heavily discounted vouchers on behalf of

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<sup>3</sup> For a detailed analysis of state tax jurisdictional principles, see “Constitutional and Other Constraints on State and Local Taxation” at [www.statetaxalert.us](http://www.statetaxalert.us).

<sup>4</sup> New York, California, Illinois, Colorado, North Carolina among others.

<sup>5</sup> For more on this, see “Nonlitigated Resolutions to Multistate Tax Disputes”, available at [www.statetaxalert.us](http://www.statetaxalert.us). The use of a tax lawyer is necessary because the attorney-client privilege protects against forced disclosure of the identity of a client who has ceased the improper practice. Nonlawyer representatives can be compelled to make such disclosures.



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vendors. Offers of discounts typically remain open for 24-hours only. In some circumstances, the discount is not effective until a minimum number of consumers purchase the same discount.

The programs appeal to consumers by providing discounts of 50 percent (or more) off of the regular retail price of the good or service. The vendor of the good or service receives promotional exposure and a new customer (and, in the opinion of some, amounts paid for unredeemed vouchers), and the organizer (e.g., Groupon) receives 50 percent of proceeds of the sold discounts. By the end of 2011, the industry's billings were \$270 million monthly.

These transactions present at least two important issues. First, for sales and use tax purposes, what is the taxable base? Is it the amount received by the vendor? The amount paid by the consumer (generally double the amount received by the vendor)? Or the retail price regularly charged by the vendor of the goods or services (generally four times the amount received by the vendor on these transactions)? There is a large variance in sales tax liabilities depending on which base is used. And there are great risks to vendors that collect the wrong amount of tax – whether too much or too little.<sup>6</sup> And, of course, differing treatments by the states add to the confusion. Businesses lacking state tax expertise are likely to fail to collect the proper amount of tax and, as a consequence, create significant exposures for themselves.

A second important issue involves the escheat of abandoned property. (Every state has escheat laws, which apply to businesses holding property that they do not own. Under these laws, businesses are required to transfer the property to the custody of a state after the property has remained unclaimed for an established length of time.) Here, states are likely to argue that vendors must relinquish amounts attributable to unredeemed vouchers. This can create a very large exposure for the businesses, many of which are unaware of their responsibilities.<sup>7</sup>

### **Federal Fines For Failure To Collect State Sales Taxes**

Israeli companies that are publicly owned, or that are planning to be publicly owned (i.e., companies traded on NASDAQ or the New York Stock Exchange), must be aware of the federal government's concerns for state tax compliance. In 2011, the Securities and Exchange Commission fined a company \$200,000 for paying state sales taxes instead of collecting the taxes from the business's customers. The SEC held that

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<sup>6</sup> An approach followed by the Illinois and Iowa departments of revenue taxes the merchandise at the vendor's regular retail price unless the voucher discloses the amount paid by the consumer. If the voucher discloses the amount paid by the consumer, that becomes the taxable base. Unfortunately, this approach creates opportunities for vendor confusion, as the amount of tax to be collected varies among purchasers of the same item.

<sup>7</sup> A detailed discussion of unclaimed property laws is beyond the scope of this article. For more, please see [www.statetaxalert.us](http://www.statetaxalert.us) vol. 1, issue 7 or, for an even more detailed presentation, see "Fundamentals of the escheat of abandoned property" also found on that website.



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the reason for the payment was a failure of internal controls, with the result that the company's financial statements were materially misstated. The federal fine was in addition to \$3.9 million in taxes that the business owed the states plus, of course, interest and penalties.

### **Personal Liability of Officers and Other Responsible Parties**

The states continue to require officers, directors and other responsible parties to pay sales tax obligations that are not satisfied by the business.<sup>8</sup> Every year, scores of rulings are issued imposing personal liability for tax compliance failures by a business.<sup>9</sup> Further, most such circumstances are concluded without a published decision.

### **Summary:**

Israeli businesses must plan for American state and local taxes. Lack of attention to these taxes can lead to tax presence and unexpected tax liabilities. Furthermore, the states' efforts to gain jurisdiction over remote sellers will increase the number of businesses held to be noncompliant with their tax obligations. Likewise, there is likely to be an increase in the number of individuals held personally liable for their business's compliance failures. To avoid personal liability, business managers and officers must ensure that their business complies with its state tax obligations.

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<sup>8</sup> For more on this tax liability, please see [www.statetaxalert.us](http://www.statetaxalert.us) volume 1, issue 3.

<sup>9</sup> See e.g., *Matter of Bartel* (California State Board of Equalization, March 12, 2012), *Smith v. Wisconsin Department of Revenue* (Wisconsin Tax Appeals Tribunal, February 14, 2012), *Petition of Steinberg* (New York State Tax Appeals Tribunal, February 23, 2012), Rhode Island Department of Revenue Administrative Hearing Decision 2012-02 (January 19, 2012) and *Dellarfano v. Commissioner of Revenue* (Massachusetts Appellate Tax Board, January 11, 2012). And see *Borger v. Levin, Tax Commissioner of Ohio* (Ohio Board of Tax Appeals, January 10, 2012) for a taxpayer win in this area.