

## State Tax Observations

# State Sales & Use Tax Audits on the Rise for Asset Management Firms

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For certain states, the pandemic has plagued tax revenue severely. To combat the shortfall, states such as New York and California have started, among other strategies, increasing their number of sales and use tax examinations. Sales and use tax, after all, is on average 40% of total state tax revenue.

Vendors selling to hedge fund/asset management companies must collect sales tax for products, and sometimes services sold within a state if they have either economic nexus or physical presence in that state. Vendors with nexus selling tangible personal property must collect sales tax unless there is a specific exemption. Sales of services, however, are generally exempt from sales tax unless they are specifically enumerated as taxable.

Many businesses that are not providing taxable services or products assume that sales and use tax filings are irrelevant to them and unnecessary. Financial service asset management firms, hedge funds, and private equity firms could easily slip into this category if they are not careful. However, these firms can often be unpleasantly surprised when they learn that certain purchases come with a hidden cost when not collected by vendors: use tax. Non-filing of use tax returns may create significant tax exposure.

## Buyer Use Tax Filing Obligations

In addition to the vendor sales tax collection responsibility, a corresponding use tax is imposed on the purchaser for the possession, consumption, or use of property within a state's borders on which sales tax has not been paid. A common scenario occurs when an in-state based financial asset management firm purchases an item from an out-of-state vendor who delivers the item for use in the state of the purchaser. If the vendor did not collect sales tax or charged an incorrect tax rate, the asset management firm bears the responsibility to pay the proper use tax. Entities that have not filed use tax returns are subject to unlimited look-back audits unless they participate in the state's voluntary disclosure program.

## What Causes Use Tax Headaches for Asset Management Firms?

In many states, certain sales tax issues are complex thereby resulting in exposure upon audit. These areas include:

- **Purchases of information services** – An asset management firm that purchases information services should be familiar with the sales and use tax rules in their jurisdiction. New York, for example (where many asset management firms are located), generally subjects information services to tax. In this state, taxable information services are those furnished by printed or any other method of duplication including the services of collecting, compiling, or analyzing information and furnishing reports. Information services that are personal or individual in nature (specifically written for the fund) and not offered to the public are not taxable.
- **Purchases of software** – Factors determining whether software is taxable include the method of delivery (i.e., hard copy vs. download) and whether it is custom or off-the-shelf. New York subjects prewritten or canned software to sales tax whether sold as a package or as a separate component regardless of the medium by which it is provided.

- **Office build-outs** – Be careful when building out a new office or location as there are many different types of assets acquired and services performed. The rules affecting the taxation of capital improvements, purchases of construction materials, purchases for resale, repairs and maintenance, and consulting are complex and require a detailed analysis.
- **Bundling of taxable and non-taxable items** – Generally, when non-taxable products and services are bundled with taxable products and services and thus sold at one price on a single invoice, the overall charge is taxable. Therefore, to avoid the entire invoice from being subject to tax, all charges should be separately stated on invoices whenever possible.
- **Soft-dollar arrangements** – Many firms engage in soft-dollar arrangements, whereby certain benefits (e.g., rent-free space, research, hardware, or administrative services) are provided to the asset management firm in exchange for services in lieu of cash payments. These arrangements are often paid for by the broker on behalf of the asset management company. In certain jurisdictions, such arrangements may give rise to a taxable event. In general, the entity that actually pays for the taxable purchase (i.e., the broker in the case above) and takes the deduction for that business expense is the entity responsible for the use tax.
- **Credit card purchases** – The use of credit card purchases is often made with no invoice backup. Auditors often seize on these purchases and assess use tax.

### Set Procedures in Place and Get Ready

In order to mitigate potential sales and use tax exposure, financial asset management firms should consider following these procedures:

1. Maintain adequate records including invoices of all purchases. This will substantiate that sales tax was already paid;
2. Review purchase invoices that do not include sales tax. Particular attention should be paid to out-of-state suppliers, including internet retailers. If possible, ask these vendors to charge sales tax on their taxable products and services;
3. Where out-of-state vendors collect sales tax, confirm that it is collected at the proper rate;
4. Consider self-assessing, registering and filing sales and use tax returns in the state where the purchases are used. Generally, filing a return will start the running of the statute of limitations, which in most states is three years; and
5. Where sales and use tax liabilities exist and returns have never been filed, consider entering the state's voluntary disclosure and compliance program, if available.

### Contact Us

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