Tax Compliance Issues Related to Leased, Rented or "Loaned" Equipment

Taxes are one of the permanent and omnipresent factors of doing business across the country and, due to the individual nature of the tax code in each of the 50 states, one of the more complex issues with which a multi-state business must deal. Taxes are applicable for a wide number of circumstances but specific to the deployment and use of equipment for credit, debit and gift card processing or check scanning for remote deposit capture services, the two primary taxes, and seemingly the most difficult with which a company must comply, are sales and use taxes and property taxes. With over 8,000 different tax jurisdictions in the U.S., tax compliance is a complex issue for many businesses.

The first task is to understand the processes and terminology utilized in these circumstances. A business is required to be registered in all tax jurisdictions in which it is "engaged in business". To determine whether a business is "engaged in business" within a taxing jurisdiction, you must establish if the business has nexus, commonly defined as:

(1) maintaining or occupying a place of business for selling or delivering goods or services;
(2) having a representative or agent operating in that state; or
(3) maintaining or owning tangible personal property for lease or rental, either directly or through a subsidiary.

The definition of tangible personal property varies per tax jurisdiction but generally includes all physical assets other than real estate. Frequently there is language that also describes it as a physical asset that is movable (not permanently constructed in a location). Because of these definitions and the nature of POS equipment utilized for card authorizations or check processing services, it is very likely that they are classified as tangible personal property in all tax jurisdictions.

In all states, if a business is determined to have nexus within a certain tax jurisdiction, it is required to register as a foreign corporation in that state and is then subject to all applicable taxes in that jurisdiction. To the extent that the business is selling taxable products in that jurisdiction, sales/use tax is due and must be collected at the time of sale and remitted to the appropriate tax jurisdiction. To the extent that the business owns and is leasing (or renting) tangible personal property, which generally includes "loaning" the equipment for a given service (considered an "implied rental"), the business has nexus and both personal property tax and sales/use tax is due. Sales/use tax would be calculated on the monthly payment (or an estimated amount for the "loaners"), collected and remitted to the appropriate tax jurisdiction. Additionally, the business will likely be required to file income taxes in that jurisdiction for some portion of its income.

So what instances are generating nexus when deploying equipment? First, if your business is selling the equipment to a customer in the same state, sales/use taxes are due. If your business is selling the equipment to a business or individual in another state, sales/use taxes are likely due in the state in

which it was sold (where the customer is located). If your business is leasing or renting the equipment to a business or individual in the same state or a different state, both sales/use tax and personal property tax is definitely due and to the state in which the equipment is located! And if your business is providing "use of the equipment needed for the operation of a service which you provide and are selling", most states would take the position that there is an implied rental and a sales/use tax is due. In the event that there is no rental rate defined in the service fee, the entire service fee may be subject to sales/use tax, even if the service is not typically a taxable service. For instance, if a bank buys check scanners and is providing a scanner to its customers as part of a bundled package for its remote deposit capture service, the bank is creating nexus wherever the scanner is installed (remember, the bank bought and has title to the scanner!) and thus, there is likely a sales/use tax due. If the location where the equipment is being used is outside of the bank's home state, the deployed scanner that costs less than $1,000 may be creating nexus for that bank, requiring it to register as a foreign corporation in that state.

As indicated above, when selling equipment you must collect the sales tax at the time of sale unless you are selling to an organization who has provided a "re-seller's certificate". A re-seller's certificate is provided to those organizations that buy and resell assets, thus transferring the obligation to collect tax to the reseller, preventing double taxation on the same on the same asset. However, the introduction of "free" equipment (terminal or scanners) into the electronic payments industry has frequently left this tax unpaid.

Often a bank or ISO buys the equipment for re-sale to its customers, and as discussed is exempt from paying sales tax on this purchase. The sales tax then becomes due and payble when the bank or ISO sells the equipment to the end-user. But if the POS terminal is provided "free" for signing up for the service, the bank or ISO is essentially retaining title to the equipment, leaving a purchased asset with no sales tax paid. This may leave the bank or ISO exposed to taxes due from the original purchase.

But who is responsible for tax compliance? The answer to this issue is not always clearly stated. Most states view the buyer/consumer as the real taxpayer but generally the onus for collecting, reporting and remitting the tax lies with the seller/vendor. As well, the big majority of states have statutes that claim a tax is due, whether or not the vendor/seller collected the appropriate tax.

What happens if a business is discovered to be out of tax compliance? The tax is obviously still due but the business will likely be charged penalties and interest, which can become significant. Most statutes allow for penalties of 5% of the original amount due plus interest that is accrued retroactively on a monthly basis (e.g. - the interest rate in California is ½% per month). The audit risk for sales and use taxes, corporate income and franchise taxes, and property taxes varies from state to state. Most states have personnel in their tax departments dedicated to identifying unregistered businesses and these staffs are growing. The normal statute of limitations applicable to taxpayers for filing taxes does not apply, since the out-of-state business is not yet a "taxpayer". Therefore, the liability can be unlimited and the interest assessed can exceed the amount of unpaid taxes. As well, the courts of that state cannot view the unregistered, out-of-state business as a "citizen" which impairs the businesses ability to defend itself in the courts of that state.

So what is the solution for a multi-state business? There are three options if it is conducting business that generates nexus in a given state. First is to register to do business in those states where it is operating and comply with all applicable tax statutes. If the revenues are large enough and recurring, this may be the best solution. The second option is to use a third-party company which allows the business to avoid nexus; equipment leasing companies and independent sales distributors (resellers) are examples of companies which allow a business to avoid nexus, by taking on tax compliance responsibility themselves. In this case, title to the equipment must clearly pass to from the business to the third party. The third and final alternative is to ignore the responsibilities of tax compliance and run the risks of discovery, leaving the business open to unpaid taxes in addition to penalties and interest. With virtually all state and local governments desperately seeking additional revenues, many are becoming far more diligent in seeking out those businesses that are not in tax compliance. Option three hardly seems worth the risk.