

Tax Compliance for the Leasing Industry

New Methodologies for Managing Tax Assignments

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ABSTRACT

THE U.S. EQUIPMENT FINANCE MARKET STUDY 2007-2008 REVEALS THAT THE OVERALL SIZE OF THE EQUIPMENT LEASING AND FINANCE MARKET HAS GROWN TO \$625 BILLION. LEASING, IN FACT, REMAINS ONE OF MOST POPULAR METHODS OF FINANCING FOR GENERAL EQUIPMENT, ALMOST DOUBLE THE VOLUME FINANCED BY TERM LOANS. HISTORICALLY, ABOUT ONE-THIRD OF THE NATION'S TOTAL INVESTMENT IN EQUIPMENT IS PLACED IN LEASING, WITH EIGHT OUT OF 10 COMPANIES LEASING EQUIPMENT.

AS THE LEASING INDUSTRY HAS GROWN, TRANSACTIONS HAVE GROWN INCREASINGLY COMPLEX AND TAX STRUCTURES HAVE BECOME EXPONENTIALLY MORE DIVERSE. IN FACT, FOR AS LONG AS THE EQUIPMENT LEASING INDUSTRY HAS PROVIDED ACQUISITION AND FINANCE ALTERNATIVES TO BUSINESSES, LESSORS HAVE STRUGGLED TO GRASP AND COMPLY WITH APPLICABLE BUSINESS PERSONAL PROPERTY AND SALES AND USE TAX STATUTES.

THIS PAPER ADDRESSES THE IMPORTANCE OF TAX COMPLIANCE TO A COMPANY'S BOTTOM LINE, COMPLEXITIES THAT CHALLENGE TAX DIRECTORS WITHIN THE LEASING INDUSTRY, AND NEW METHODOLOGIES FOR MANAGING TAX ASSIGNMENTS THAT DRIVE OPERATIONAL EFFICIENCY AND THE ACCURATE ASSIGNMENT OF TAXES.

THE AVERAGE NUMBER OF U.S. SALES TAX RATE CHANGES PER YEAR HAS GROWN BY 28 PERCENT SINCE THE LATE 1990S. IN 2006 ALONE, THERE WERE 689 RATE CHANGES.

The Importance of Tax Compliance

Business taxes, mostly in the form of business personal property and sales and use tax, are healthy contributors to the budgets of almost all state and local governments. With so much at stake, it is no surprise that they are increasingly focused on making sure a company owning an asset within any of their tax jurisdictions files applicable documentation and pays all required taxes.

Thanks to more aggressive state collection strategies, even just one dollar of income can trigger a jurisdiction's registration and tax reporting requirements. In fact, if a company does not proactively register and pay business personal property and/or sales and use tax, the state jurisdictions are more than ever likely to seek out and find them.

We've seen significantly increased efforts on the part of states to identify delinquent taxpayers and collect taxes, said Steve Kranz, formerly of the Council on State Taxation (COST), a Washington, D.C.-based trade association that represents the interests of approximately 550 of the nation's largest taxpayers on state and local taxation issues. Use of outside discovery and collection contracts is a growing phenomenon.

As an example, the Tennessee Department of Revenue has increased its focus on compliance through a variety of initiatives. According to Loren L. Chumley, former commissioner of the Tennessee Department of Revenue, the department, increased its audit staff by 14 positions and, with those positions, established a specialized franchise and excise tax unit and bolstered its discovery unit.

The risks and costs of tax noncompliance are high. Compliance failure can result in stiff financial penalties and accrued interest for businesses that can potentially add up to thousands of dollars, and possibly even criminal charges. As an example, Monitor Daily, the magazine for the equipment leasing and finance professional, cited a company that did not remit taxes for almost seven years and was assessed more than \$80,000 in penalties on the \$400,000 it owed.

In some cases, non-payment of taxes may result in liens on the leased equipment. Many lenders will not even consider providing financing to a company that cannot demonstrate compliance with applicable sales, personal property, and income taxes. This threatens existing lines of credit, the possibility of obtaining additional future financing, and the very business itself.

The Problem with Tax Jurisdictions

Unfortunately, even the best-intentioned companies have inherent problems identifying correct tax jurisdictions and paying proper taxes. For as long as the leasing industry has been in existence, there has never been a clear, concise, consistent approach to handling tax[es], says Hugh Connelly, COO of First Lease.

In general, businesses that operate across state and jurisdictional lines and lease interstate equipment find myriad differences in federal, state, and local tax assignments. The combination of tax statutes, regulations, state and local jurisdictional administrative rules, as well as IRS guidelines, continue to challenge corporate finance professionals throughout the U.S. who deal with financial reporting for leasing and sales transactions.

On one hand, business property tax boundaries are not always the same as sales tax boundaries (Texas Michigan, Ohio, Wisconsin, and Illinois are notable examples). With over 10,000 taxing jurisdictions in the U.S., and more than 450 varieties of state, local, and special tax entity returns, it is nearly impossible to keep up with the hundreds of rate changes that occur each year and the widely differing reporting and remittance requirements. The volatility of sales tax rates, particularly, is increasing according to Vertex, Inc., which has studied tax changes over the past few decades. Vertex found that the average number of U.S. sales tax rate changes per year has grown by 28 percent since the late 1990s. In 2006 alone, there were 689 rate changes.

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Business personal property tax compliance also brings its own set of headaches for the leasing industry. It is typical of large, national leasing companies to have thousands of pieces of equipment and even more business property tax returns. Consider, for example, Pitney Bowes, a Fortune 500 company and a major player in postage machine leasing. With over 1.4 million leased machines throughout the U.S., the company's tax department files over 7,000 separate business property tax returns based on equipment location.

While leasing can reduce or defer sales and use tax in many situations, it is not unusual for jurisdictions to impose multiple levels of tax on leasing transactions, particularly where complex financial transactions occur after the initial risk is executed. The risk of double taxation is particularly acute where mobile property is involved, because the property may migrate between two jurisdictions adopting different rules or taxation of leased property.

Determining correct tax jurisdictions is critical to significantly reducing incorrectly filed tax returns. Many leasing businesses with multiple locations and tax compliance responsibilities in many jurisdictions have turned to traditional automated systems to meet the tax jurisdiction challenge. Using real-time tax systems, they are integrating sales, financial management, and enterprise resource planning (ERP) systems and automatically applying relevant tax rates based upon traditional ZIP Code or ZIP+4 methodologies to verify leasing addresses and jurisdictions. These programs can easily cost more than \$10,000 per year, yet by themselves they fail to address an essential flaw in their methodology — the problem with ZIP codes.

The Problem with ZIP Codes

The ZIP Code™ is a postal delivery system created by the U.S. Postal Service (USPS) in 1963 for the convenience of expediting mail delivery. It was never intended to guide accurate and equitable tax assignments, yet most state and local tax assignments throughout the U.S. are based

on ZIP Codes™. This system may have worked well enough in the past, but it is extremely error-prone today. For leasing companies responsible for identifying tax responsibilities by jurisdiction, the result of these inconsistencies is eye-opening: despite the critical need to assign tax jurisdictions correctly, it perhaps comes as no surprise that, in the end, all territory assignments are estimated to have an error rate of about 10 percent.

Seemingly simple to use, Zip Codes™ have inherent characteristics and limitations that consistently cause ongoing and, ultimately, expensive problems for tax jurisdiction assignments.

First of all, ZIP Codes™ and ZIP+4s don't always correspond to jurisdiction boundaries. In addition, ZIP Code™ and ZIP+4 coverage changes frequently as the USPS implements additions, deletions, and other changes at the rate of 600,000 each month in the ZIP+4 files alone.

Further complicating the landscape, some states require that jurisdictions correspond not just to ZIP Code™ requirements, but to political or census boundaries as well, which ebb and flow along with local populations. States may establish special districts (such as Texas) based on municipal utility districts, library districts, and drainage districts for example, resulting in still higher tax assignment errors.

Of the approximately 20,000 municipalities across the U.S., as many as 30 percent of ZIP Codes™ are in conflict with municipal, county, and even state boundaries, resulting in taxes being charged where none are due. They often lag rapid development as well, failing to include, for example, entirely new sub-divisions.

Adding Complexity: Change of Address

With the correct address, sales tax and property tax assignment at the time of contract is fairly straightforward by managing the correct tax rate assignment per precise customer and business location. Where it gets tricky for lessors is when

THE RESULT OF ACCURATE TAXATION IS AN INCREDIBLE IMPACT ON LABOR SAVINGS AND—BY REDUCING THE NUMBER OF MISFILED TAX RETURNS—THE BOTTOM LINE.

a customer or business moves and changes their address. Since the lessor is considered the property owner in the agreement, they are responsible for paying the taxes. That said, if the lessor does not have a systematic way of monitoring customer and business address changes, and cross-referencing those address changes with their leasing portfolios, they are at risk of charging too much or too little tax. Once discovered, the lessor must send a change of payment or tax bill letter to their customers informing them of their mistake, which can damage the customer relationship. This is especially true for customers and businesses that do not receive physical statements, since the usual return to sender postal prompt is not an option. Thus, receiving immediate notification of change of address is vital to accurate taxation.

Solving the Puzzle: Location Intelligence

Location intelligence is a new methodology that uses geography to solve a myriad of location-based business problems challenging the leasing industry. By bringing street address-level precision to county, municipality, and special district tax assignments, it is also the right answer for the correct assignment of tax jurisdictions.

Location intelligence combines multiple layers of geographic data to provide a better scope of understanding a physical location, going far beyond ZIP Codes™, to correct, clean, and standardize street address information to reflect accurate street addresses and geographic locations. Location intelligence combines geocoding—the assignment of latitude and longitude to street address locations—and spatial analysis—the assignment of territories—to map rich sets of data for use in such far-ranging activities as customer profiling, disaster preparedness, risk management, coverage locators, network prequalification, and regulatory reporting. Combined with the right data layers, location intelligence is particularly well suited to the leasing industry in meeting the challenge of complex allocations and assignments.

A Solution for Tax Challenges

Remember Pitney Bowes? As a global leader in information management, they are one of the innovators in location intelligence solutions. Pitney Bowes has developed a software solution that finally overcomes the inherent problems associated with state and local tax jurisdiction assignments, not only for themselves, but for the leasing industry as a whole. Utilizing location intelligence as the foundation, the product suite, Enterprise Tax Management, takes the time and the guesswork out of determining the correct tax jurisdiction for business personal property and sales and use tax. The result is an incredible impact on labor savings and—by reducing the number of misfiled tax returns—the bottom line.

Each of the individual Enterprise Tax Management tax modules takes advantage of powerful GeoTAX® geocoding and spatial analysis technology for providing the most up-to-date and accurate jurisdiction assignment by bringing together address standardization, street-level geocoding, and the boundary data sets to accurately locate fixed assets. Another Pitney Bowes product, MapInfo Professional®, is also used to overlay linear assets onto the tax boundary data to automatically calculate the miles of material within a specific tax jurisdiction. These tools easily interface with software from leading tax compliance providers like Tax Compliance Inc. (TCI), with the ability to monitor tax jurisdiction changes daily. While they are not intended to replace the tax filing products currently being used within an organization, they can be easily integrated into native platforms like AS400, UNIX, Linux, and Windows—as well as client/server and web-based applications—to significantly reduce the number of incorrectly filed returns.

The result of this innovation is tax assignment accuracy—and the confidence of knowing the leasing organization has substantially raised its potential for profit and lowered its financial risk and regulatory liability.

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Next Steps

Business leaders in the leasing industry have every reason to regard the accurate management of state and local tax assignments as a critical tipping point of their business: indeed, thousands of dollars in revenue, and the health of the franchise, may rest in the balance.

Proper diligence requires that each leasing and financing organization investigate and adopt ambitious, forward-thinking policies and practices to ensure the timely accuracy of tax data and information. It is a comfort knowing that there are solutions ready and available today in the marketplace.

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