

A STATE TAX TIME BOMB

Article Posted 11/8/00

You just finished reading a memo from your company's treasurer advising you that a southern state had billed the company for six figures worth of back taxes, interest and penalties dating back to 1989. To make matters worse, he told you that the company had also received questionnaires from two more state revenue departments indicating that they thought your company may be "doing business" in their states.

What's this all about? How can we owe money to these states? We don't have offices or employees in those states. Didn't one of our advisors tell us that we were engaged in interstate commerce and, therefore, not subject to such taxes?

Over the next few weeks, the picture gets even more confused. The company continues to receive questionnaires from several states. Another state has sent you a bill, which is larger than the first. How far back can they go and how do they know about us? We're not a "Fortune 500" company.

Unfortunately, many small companies are beginning to experience events similar to what has just been described. What formerly was a non-issue for small and medium size businesses has become an expensive and frightening nightmare. What is going on and why does it seem to be getting worse?

The founding fathers desired that business between the various states of our country not be impaired by each state trying to tax goods and services crossing over state lines. Accordingly, for many years, the state in which a company was "domiciled" generally taxed the company for its profits and capital, and taxed the sale of goods in that state. If a company did not maintain a physical presence in another state, such as offices or employees, that state would not generally be able to tax the company. With regard to taxes on the actual goods or services, the domiciliary state would tax the products staying in state and the company was responsible for collecting and paying such state's sales taxes. In other states, the customer was technically responsible for paying use taxes, but rarely were such use taxes ever paid. However, if a company had a physical presence in that state, such as a branch office, it would be required to collect the use taxes on products shipped from its home state to the outlying state.

For many businesses, state and local taxes for jurisdictions other than its home state were really of little concern. Even if there was a vague understanding of the requirement to file and pay taxes, or at least the possibility of an obligation, most companies ignored or buried the issue because it cost time and money and certainly hurt the bottom line. In addition, how was the company going to get caught?

Why is this arena changing? What is happening to cause a dramatic increase in state and local audits, tax billings and collections? Why is this now a critical issue for every CEO; even of small companies?

As in every other area of life, state and local governments require money to operate. In order to effectively increase revenues, governments must either increase tax rates or do a better job collecting taxes that it believes are owed. Accordingly, over the last few years two trends have occurred with regard to business taxes. State and

local governments have pressed for court interpretations that would allow them to tax companies doing business in interstate commerce. At the same time, these governments are devoting more resources toward collecting their taxes.

Rather than give a running account of the various cases that have given rise to this changing landscape, it is sufficient to say that the physical presence test of old has changed significantly. Courts appear to be moving in the direction of allowing states to tax companies based upon "economic presence", using very limited interpretations of the physical presence rules. For example, if a company ships its products into a state by common carrier, (i.e., in trucks the company does not own), most courts have held that "nexus" (a connecting link) is not present; therefore the state does not have the power to tax. However, if the company allows its own trucks or employees to deliver the product into the state, most state revenue departments will attempt to tax the company, and the state may have support from its courts.

Do your employees train the customer on your products at the customer's offices in another state?

Do you lease your products to your customers located in another state?

Does your warranty require that your product be serviced at the customer's location in another state?

Each of the above situations, and many others, may cause a state revenue department to attempt to tax your company. At the very least, companies doing business of any kind across state lines should obtain the services of a multistate tax professional to assist them in making an analysis of the company's methods of business and its tax exposure.

Unfortunately, once an analysis is actually made, it may be too late to register with other states as a foreign company and begin to pay its taxes prospectively. What about the past years? How can we fix the problem? For many companies, management determines that it's better to bury the problem even deeper and hope the company isn't noticed.

If that seems like a good idea, it's time to rethink the issues.

As we all know, there are many advantages to the computer age. However, as George Orwell predicted in 1984, a major disadvantage may be the incredible depth of databases out there in cyberspace that maintain records on your company. As states have begun to look to increase revenues, many have empowered their audit divisions to search all available data for tax "dodgers". Some states even employ field auditors to live and work in other states to locate companies that may be doing business in the state for which they work.

Information sharing arrangements between states are prevalent, so that when one finds an offender, its name is passed on to the other member states to see if the company may also owe tax in those states. The Southeastern Association of Tax Administrators is just such an association, covering twelve southern states from Florida to Kentucky. In addition, there is a Multistate Tax Commission with 39 member states which maintains an audit department with the express intent to find tax reprobates.

Once a company is "caught" by a state, it may be taxed, even if the company really doesn't believe it owes the tax. As in other types of litigation, the cost of fighting often exceeds the amount of taxes the company could have paid had the company come forward voluntarily. For example, once a state contacts a company for failure to file, there will generally be no statute of limitations on past years for which the state can collect. The state can go back many years in its audit and charge interest and penalties. In addition, many states have adopted statutes which hold officers and directors personally liable for the company's failure to file and pay. Moreover, in some states, criminal penalties exist, and if the state can prove that a company knowingly failed to file or fraudulently failed to pay taxes, an officer could find himself or herself in a very precarious situation.

So what can a company do to remedy the situation without killing itself? Most states maintain a voluntary disclosure program within the tax revenue department or audit department. While it is sometimes difficult to locate the right bureaucrat, a professional familiar with the process who knows the right contacts within the various state departments can usually negotiate a settlement with the state tax departments. While there are many nuances, it is generally possible to meet with state officials on an anonymous basis so that an agreement can be reached, satisfactory to both the company and the state, without the company baring its corporate soul. Care must be given to the manner in which contact is made with each state, and the party who contacts them, so that anything discussed can not later be used against the company if an agreement can not be reached.

Fortunately, if approached properly, these stories can have a happy ending. Recently, a small 200 employee company, doing business in more than thirty states, was able to reduce a potential \$2-3 Million dollar tax liability to an actual cost of approximately \$200,000.00, including legal and accounting costs. This was accomplished through judicious use of negotiated voluntary disclosure agreements.

It is now a necessity that all companies, large and small, consider their potential multistate tax liabilities and develop a plan for dealing with them before a state audit department arrives in their lobby.

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