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46 State Tax Notes 289 (Oct. 22, 2007)

Identifying and Handling Multistate Tax Issues

by Timothy P. Noonan

Litigating tax cases and handling audits usually are the more exciting aspects of practice for the state and local tax (SALT) practitioner. But an important and often overlooked aspect of tax practice involves tax compliance. Obviously, when there is an audit or ongoing litigation, there is a clear problem to solve and particular ways to go about solving it. But what happens when there are no audits? What if there are lingering issues in one or several states that historically have been just swept under the carpet?

The seasoned state and local tax practitioner has to know not only how to litigate a tax case, but how to manage individual and multistate tax compliance issues, which are often just as important, even if not always as exciting. Few taxpayers fail to appreciate the complexity of tax compliance in each of those states and the thousands of localities within them that also impose various types of taxes. The taxpayers that don't deal with the complexity usually run away screaming or just stick their heads in the sand.

But now that state tax departments are becoming smarter and more aggressive, many of those companies are starting to reexamine their state tax compliance, or the lack thereof, and are looking for ways to identify and resolve multistate issues. Before discussing different practical methods and strategies that often can be used, however, it's important to first lay the groundwork, discussing the most important legal issue often involved with multistate tax compliance, that of nexus.

Identifying Multistate Issues: It's All About Nexus

Usually helping to identify a company's potential multistate tax issues starts with questions about nexus. Obviously, not every corporation that engages in business activities in the United States is subject to every state's tax jurisdiction. A state's ability to impose its tax obligations on an out-of-state corporation -- whether those obligations be for corporate, sales, franchise, or other taxes -- is limited by the U.S. Constitution and may be further limited by federal and state laws. The nature and frequency of contacts that an out-of-state corporation must establish in a state before the corporation may be subject to that state's taxing jurisdiction generally is referred to as nexus. Literally, the term "nexus" means connection. For state tax purposes, the term nexus is used to indicate that the connection between an out-of-state corporation and the taxing state is sufficient to allow the state to impose tax collection responsibilities over that corporation.

Where does it come from? The principal provision that limits states' jurisdictional powers to impose tax responsibilities on an out-of-state corporation is the commerce clause of the U.S. Constitution. The commerce clause provides: "Congress shall have power . . . to regulate commerce with foreign nations, and among the several states, and with the Indian tribes."[1] Though phrased as a grant of regulatory power to Congress, the clause has long been seen as a limitation on state regulatory powers, as well.[2] That interpretation denies states the power to unjustifiably discriminate against or burden the interstate flow of articles of commerce. In *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), the Supreme Court enunciated the modern four-prong commerce clause test that is used to determine whether a state tax is constitutional. The first prong of this test requires that a state tax must be applied to an activity that has a *substantial nexus* with the taxing state.

Nexus issues come up both in the sales tax and income tax contexts, and generally the rules are similar. In the sales tax area, liability tax collection is premised on nexus. As most practitioners know, the U.S. Supreme Court's decision in *Quill* set the bright-line test in reaffirming that the commerce clause prohibits a state from imposing sales or use tax compliance responsibilities on an out-of-state corporation if that corporation has no *physical presence* within the taxing state.[3] New York's Court of Appeals also has indicated that while physical presence is required, it need not be more than the "slightest presence."[4] Similarly, other Supreme Court cases indicate that the type of physical presence necessary to create sales tax nexus may be as slight as a temporary presence in the state of the corporation's property or personnel, and that any contact with the taxing state beyond the mails or common carrier may give rise to sufficient nexus. In *Felt and Tarrant Co. v. Gallagher*, 306 U.S. 62 (1939), two soliciting sales agents and a rental office in the state created sufficient nexus. In *Standard Steel Co. v. Washington Revenue Dept.*, 419 U.S. 560 (1975), one resident employee operating out of his home

in the taxing state created sufficient physical presence. In *National Geographic*, 430 U.S. 551 (1977), two business offices unrelated to the taxpayer's sales activities within the state created sufficient physical presence. The list goes on and on.

States have taken their cue from the Court, and have been equally aggressive in asserting the existence of nexus. In *Orvis* the occasional in-state solicitation by out-of-state traveling salesmen created sufficient physical presence. An administrative law judge in New York's Division of Tax Appeals recently came to the same conclusion, holding that semiannual customer visits were enough to create nexus for an out-of-state tobacco supplier.[5] California held in Sales Tax Counsel Ruling 220.0015 that occasional visits by employees to attend trade shows created sufficient physical presence. And a Texas policy letter ruling (9911897C) holds that one independent contractor answering customer e-mail from her home is enough to create sufficient physical presence.

As mentioned, the nexus rules applicable to state corporate income taxes are similar, although they are not entirely clear because the U.S. Supreme Court has not specifically ruled in that area. Some states have found that a corporation's mere purposeful exploitation of a state's market for services and the presence of intangible property in a state are enough to satisfy the U.S. Constitution's limitations on a state's jurisdiction to impose income taxes. The now infamous *Geoffrey* case and its relatives are examples of that other test.[6] And as most practitioners know, federal law (Public Law 86-272) provides some additional protections to sellers of tangible personal property -- but only for corporate income-based taxes.

Determining Applicable Taxes

But even after nexus is determined, and before decisions are made about compliance, questions have to be asked about whether and to what extent a company even has a tax liability. Usually, practitioners generally should be concerned with responsibility for *four* separate tax types: payroll tax (including employee responsibility for individual income tax), corporate income tax, corporate franchise tax, and sales taxes. Not all states impose every tax type, and not every company will have responsibility for all taxes.

For instance, international companies often make the mistake of assuming that their protection from federal-based taxes under some form of treaty involving the United States and other countries also protects them from state-based taxes. None of those treaties, however, include states as parties. No state has a treaty regarding taxes in place with a foreign country. That said, special rules may apply in some states that would exempt a federally exempt company (or employee) from state taxes. That is, if a company's employees are not subject to U.S. federal tax, it is possible that they would be similarly exempt from state taxes. That is because most of the states use federal adjusted gross income as the starting point for the determination of personal income taxes. Thus, if an employee is exempt from federal taxes and therefore has no federal taxable income or AGI, he or she similarly would have no state taxable income by virtue of the state's computational rules. The same analysis could apply in the corporate income tax context. States that use federal taxable income as their starting point could provide protection for companies that have no federal taxable income due to a treaty.

But the point is, even with nexus, there are ways for companies to avoid compliance with tax obligations in 50 states. It just takes some looking to find out.

Resolving a Multistate Tax Problem

So that is why the state and local practitioner is often such a "happy" sight to taxpayers inquiring about multistate tax obligations. Often, because so many states take such an aggressive position regarding nexus and taxability issues, we SALT practitioners are often bearers of bad tidings. Nonetheless, we can at least offer some hope, and I hope add some value, in the compliance process. There are a variety of ways, some discussed below, for companies to quickly and safely address multistate tax concerns while keeping themselves solvent and out of the newspapers.

Some companies consider "prospective" compliance the best option. That obviously is sufficient to ensure compliance in the future, but it leaves open the possibility of investigations or audits for previous periods. That can especially be a problem, given that questions on the registration forms the company will have to fill out in the state ask "why are you registering?" and/or "how long have you been here?" Those questions can be difficult to answer if there are past issues.

Other companies often consider, particularly in the international cross-border context, the creation of a new legal entity, generally formed in the United States, to handle all U.S. operations on a going-forward basis. The idea behind that compliance strategy is to engage in business in a new, untainted entity, with the obvious goal of avoiding issues in earlier years that may exist with the old company. Here again, that approach is sufficient to address going-forward concerns, and

it also makes it a lot easier to fill out that initial registration form. But it still leaves the company open to audits and investigations for previous years' taxes.

And if the previous years' tax liability is extremely significant or if the company's noncompliance spans more than just a few tax years, many companies consider participating in state "voluntary disclosure" programs. Those programs allow taxpayers to voluntarily come forward and enter into compliance with a state's taxing provisions without fear of civil or criminal penalties or excessive lookback periods. Generally, states will allow taxpayers to pay three years' worth of taxes plus interest only, and will limit any audits or investigations to this three-year period. Moreover, companies can work with the Multistate Tax Commission, which has a program designed to assist taxpayers with voluntary disclosures in several states. We have found the MTC to be an amazing resource and quite efficient in handling complex disclosures in many states.

Finally, through the Streamlined Sales Tax Project, many states are offering amnesty to taxpayers that are willing to participate in the project on a going-forward basis. Although that amnesty is available only in participating states and participation could create other issues and problems that have to be considered for particular taxpayers, the benefit of the amnesty program is that it requires compliance only on a going-forward basis. Participating taxpayers are absolved of all previous years' tax responsibility, at least for sales tax purposes.

Conclusion

Sometimes companies need more help with potential audits than they do with existing battles. Being able to identify those problems and, more importantly, knowing how to resolve them, is an important skill and one needed for those who practice in the state tax area.

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FOOTNOTES

[1] U.S. Constitution, article 1, section 8, clause 3.

[2] *See e.g., Oklahoma Tax Commission v. Jefferson Lines, Inc.,* 514 U.S. 175 (1995).

[3] *See Quill Corp. v. North Dakota*, 514 U.S. 298 (1992).

[4] *See Orvis Co., Inc. v. Tax Appeals Tribunal*, 86 N.Y.2d 165 (1995).

[5] *J.C. Newman Cigar Co.*, administrative law judge (Sept. 27, 2007). (For the ALJ ruling, see *Doc 2007-22581* [**PDF**] or *2007 STT 197-14* .)

[6] *See, e.g., Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, *cert. denied*, 114 S. Ct. 550 (1993).