Out-of-State Operations Can Generate Penalties

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Are you at risk for penalties and back taxes for your operations in other states? Could you be at risk even if you don't have employees or facilities out of state? The answer is definitely YES. Even minimal activity may put you on a state's radar. As states increasingly seek revenue through stepped-up income tax and sales/use tax enforcement, more businesses find themselves on the receiving end of queries about their activities outside their home state – and uncomfortable with their answers.

What causes state, sales/use tax liability?

Almost every business has received one from another state, though the titles vary. Called "business activity questionnaires," "commercial activity questionnaires" or "nexus questionnaires," these forms ask 10 to 60 questions about your company's activities in a given state, requiring that you respond quickly. The questions seem simple enough, but your answers – even a single answer – can produce substantial tax exposure.

These questionnaires probe to determine whether your business has "nexus" with that state. "Nexus" means that you have enough presence in a state that you must comply with its sales, use and income tax laws. You may ask, "Why did I receive the questionnaire and how much presence is enough?" There's no single answer; every state has different methods and rules. Perhaps the Missouri revenue agent spotted one of your company vehicles on a Missouri highway. In Missouri, like most states, even if your company has all of its employees, equipment, and real property in Kansas, you still might have "nexus" with the state of Missouri for sales tax purposes.

Although each state evaluates your business activities differently, there are common issues that the states look for in determining whether you should be paying tax in their state. These issues, which are not all-inclusive, include making deliveries in a company vehicle, having employees or sales representatives in a state, main- taining an office or warehouse, storing inventory, providing repair or warranty services (either directly or through a third party) or accepting sales.

What are the penalties?

The consequences of establishing after-the-fact nexus with a state can be dire. States can "look back" to the date a company first established nexus, and require payment of sales, use and income tax from that date. Often, the look back period is longer than the company's records of activities in the state, which may lead to estimating a company's tax liabilities. In the case of income tax, the look back period may certainly exceed the time limit for an amended Kansas income tax return, resulting in paying tax two or more times on the same income. Adding to the bite, penalties and interest can at times add up to as much or more than the actual taxes owed. Worse yet, a company's tax liability may result in a personal obligation for company officers. The state tax agency could put a lien on your personal assets for tax liabilities you never knew existed.

Budget shortfalls and decreased federal funds available to the states have caused the states to aggressively seek out and pursue companies that conduct business in their states. In many cases, these states have also billed the companies the taxes that should have been collected and remitted. Given the states' new posturing, the "wait and see" approach to registering in and complying with the states' tax laws becomes a dangerous waiting game rather than a viable tax planning strategy.

How can I minimize my tax exposure?

There is some good news to report. There are constitutional and statutory limitations on the states' power to tax, plus various programs that can substantially reduce, or in some cases, completely eliminate past tax liabilities. But do not count on the states' tax collection agencies to bring these limitations and programs to your attention.

The variation and complexity of state nexus requirements makes it even more important to discuss any out-of-state business operations with a state and local tax consultant to develop a plan for your activity in other states – and avoid surprises down the road. Even if you are required to register in other states, a consultant can help you evaluate the best strategy for lo- cating your various operations to minimize your tax liability. A professionally prepared nexus review study can help you identify those states in which you may have sufficient nexus to require compliance with a state's tax laws. This enables you to take advantage of any state programs that may reduce or eliminate a potential tax liability. In any case, it's critical that you take a proactive approach to managing your state and local tax issues before you re- ceive a questionnaire raising issues you'd prefer not to consider.

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