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Navigating State Tax Issues

Because state tax departments are becoming smarter and more aggressive, a proactive wind energy company must examine its state tax compliance and find ways to identify and resolve multi-state tax issues.

Failure to address these concerns can result in significant liabilities in multiple jurisdictions. There are a number of different practical methods and strategies available, but first, it is important to lay the groundwork by discussing the most important legal issue often involved with multi-state tax compliance: nexus.

A state's ability to impose its tax obligations on an out-of-state corporation – whether corporate taxes, sales taxes, franchise taxes or other taxes – is limited by the U.S. Constitution and applicable federal and state laws.

The nature and frequency of contacts that an out-of-state corporation must establish in a state before the corporation is subject to that state's taxing jurisdiction is generally referred to as "nexus." The term refers to whether there is sufficient connection between the corporation and the taxing state to allow the state to impose its taxes.

To understand the impact of nexus on multi-state companies, consider a large wind farm developer. Let's say the developer has its primary place of business in New York and operates wind farms in five other states. Clearly, the developer is subject to New York's corporate income tax. But because it has a physical presence in those other five states, the developer will be subject to their tax regimes as well, including corporate income taxes. If the company then sends its employees from New York to three more states or employs consultants or agents there to develop new wind farms, the company could potentially have nexus with those states, depending on each state's nexus rules.

The Commerce Clause of the U.S. Constitution denies states the power to unjustifiably discriminate against or burden the interstate flow of articles of commerce.

In Complete Auto Transit v. Brady (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 requires that a state tax be applied to an activity that has a substantial nexus with the taxing state.

Nexus issues come up in the contexts of both sales tax and income tax, and generally, the rules are similar. One case set the bright-line test prohibiting a state from imposing sales-tax or use-tax compliance responsibilities on an out-of-state corporation if that corporation has no physical presence within the taxing state.

Other Supreme Court cases indicate that the type of physical presence necessary 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 can create sufficient nexus.

In Felt and Tarrant Co. v. Gallagher (1939), two soliciting sales agents and a rental office in the state created sufficient nexus. In Standard Steel Co. v. Washington Revenue Dept. (1975), one resident employee operating out of his home in the taxing state created sufficient physical presence. The list goes on and on.

Nexus rules

States have been aggressive in asserting the existence of nexus. In one case, the occasional in-state solicitation by out-of-state traveling salesmen created sufficient physical presence. California has held in Sales Tax Counsel Ruling 220.0015 that occasional visits by employees to attend trade shows created sufficient physical presence.

Furthermore, 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.

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 this area. Some states insist that a corporation's mere purposeful exploitation of a state's

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market for services – and the presence of intangible property there – are enough to satisfy the constitutional limitations on a state's jurisdiction.

Public Law 86-272, through which Congress limited the power of states to tax multi-state companies, provides certain additional protections to sellers of tangible personal property – but only for corporate income-based taxes.

There are a variety of different ways for companies to quickly and safely address multi-state tax concerns while keeping themselves solvent and out of the newspapers.

Some companies consider prospective compliance the best option. This method obviously is sufficient to ensure compliance in the future, but it leaves open the possibility of investigations or audits for previous periods.

This risk can be a problem, given that one of the questions on the registration forms the company will have to fill out in the state asks, "Why are you registering?" and/or "How long have you been here?" These questions can be difficult to answer if past issues are present.

Other companies, particularly in the international cross-border context, can create a new legal entity, generally formed in the U.S., to handle all U.S. operations on a going-forward basis. The idea here is to engage in business in a new, untainted entity, thus leaving prior years' issues with the old company.

Again, this approach is sufficient to address future 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 prior years' taxes.

If the prior year's tax liability is extremely significant, or if the company's non-compliance spans more than just a few tax years, many companies consider participating in state voluntary-disclosure programs, which 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 look-back 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.

Companies can also elect to work with a multi-state organization called the Multi-state Tax Commission, which has a specific program to assist taxpayers with voluntary disclosures in several states.

Finally, through a multi-state project known as the Streamlined Sales Tax Project, many states are offering amnesty to taxpayers willing to participate on a going-forward basis. Participating taxpayers are absolved of all prior years' sales tax responsibility.

For companies of the new economy that are looking toward the future, success requires meeting challenges and devising solutions before the problem arises. In the area of multi-state tax, a forward-looking approach requires a company to identify the states in which it may have nexus, what its potential liability might be and the best strategy for addressing that liability.

Multi-state tax practitioners offer a valuable resource for growing businesses by developing a strategy for multi-state tax compliance and determining where a company has nexus and where it might have nexus in the future.

With a tax compliance plan in hand, a company can keep its focus on business objectives rather than on battles with state tax departments.

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