

# Assess tax exposure

The importance of tax planning when operating in multiple states

It is not unusual for companies to do business in multiple states with a wide variety of operations. In addition to providing facilities for employees, companies may provide delivery services, installation and maintenance services, operate distribution facilities, sell merchandise over the internet and provide miscellaneous customer service offerings. As companies expand and grow into new markets and new businesses, state and local tax planning is critical.

*Smart Business* talked to John Corn, director of Habif, Arogeti & Wynne, LLP's state and local tax service practice, about some of the tax planning considerations necessary for companies currently operating in and expanding into multiple states.

## What are the different types of taxes that states can assess?

Different states assess different taxes, using various methods and rates. How many tax challenges the company will actually face depends on varying state rules. Examples of tax on interstate commerce include:

- Business income tax based on allocation of sales, in-state facilities a company owns and maintains, activities and offices of sales representatives, and even independent contractors operating on a company's behalf

- Nonbusiness income tax on rents, dividends and interest

- Franchise tax on a company's net worth and net income generated from business activities conducted within a state

- Sales tax on goods delivered in the state and sales of related product warranties or services, including drop shipping of merchandise to customers

Potential liabilities for tax on interstate commerce may require adjustment of pricing strategies to cover the company's tax liability and remain profitable. It may actually be cost prohibitive to operate in certain states.

## When is business significant enough for a company to become a taxpayer?

One of the first steps in multi-state tax planning is determining 'nexus' or connection with a state. Whether or not a company has nexus with a jurisdiction establishes if it is a taxpayer and required to meet certain obligations, including the payment or collection of state taxes such as income, franchise, or sales and use taxes. Most states have a 'bright line' test used to determine nexus. In effect, states specify the minimum physical pres-



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ence required before a state can justify levying state income taxes against those companies operating in its jurisdiction.

In many cases even minimal business activity can trigger a filing requirement. In general, the standard for doing business encompasses the location of real or personal property, location of employees, where and how sales are solicited, and where revenue is sourced. If a business has nexus then it must comply with all state statutes and regulations, including registration, collecting and remitting taxes due to the state.

Often the frequency with which certain business activities occur will determine if nexus is established. Clear documentation of the company's operations and an understanding of the company's accounting system are very helpful when evaluating the level of tax exposure.

## What are the various factors states evaluate when determining nexus for tax purposes?

**Business situs.** This includes states where you maintain company property (such as offices, data centers, wholesale store outlets, storage warehouses and distribution facilities), employ staff or work with other business representatives.

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**Physical presence.** Even without an office or other facilities in a state, temporary presence of your employees, agents or property may subject you to a state's taxing jurisdiction — for example, the use of company vehicles or personnel to deliver products and services into the state.

**Commercial domicile.** This is the state where your business is headquartered. You're liable for taxes in your commercial domicile, when applicable, only on the business you conduct in that state and, if state law provides, on all of the nonbusiness income of the company (such as dividends and interest).

**Corporate domicile.** This is the state in which your company was incorporated or chartered, which may differ from your commercial domicile. You may be liable for all business taxes levied in your corporate domicile.

**Economic presence.** Even if you have no physical presence, some states may levy taxes based on 'economic' benefit or activity, such as on income-generating trademarks your company owns, business transacted through the Internet, or products shipped into the state, even if delivered by common carrier. Ohio's commercial activities tax is a good example, imposing a low tax rate on 'gross receipts' from Ohio sources.

## What else should businesses know?

Prepare for increased scrutiny. Be aware that simply qualifying the company to conduct business in a state may trigger tax obligations within that state.

To increase revenue, state governments are working to increase tax rates and dedicating more resources to collect taxes from businesses engaging in interstate commerce. To this end, states may employ staff to conduct Internet searches and use field auditors to discover noncompliant companies doing business in their states.

If a state determines that your company has failed to properly comply with registration requirements and proper payment of tax liabilities, your company may be assessed back taxes with costly penalties and interest. Companies should seek the help of experienced tax specialists who understand state and local tax policies, especially since state tax law is so complex and lacking in uniformity. <<