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General Counsel and State Tax Notices

General counsel often do not receive notices from tax agencies. These notices generally go to the financial officer's departments or to whomever handles taxes.

Notices from the Internal Revenue Service generally get attention, but notices from state or local agencies often get ignored because the amounts are small or the recipient does not think that the company has nexus (sufficient contacts) in the state to be subject to tax.

However, many states, including California, are changing their nexus rules and are becoming more aggressive in issuing assessments when ignored. Assessments left to go final can generally be challenged only after payment of tax and they may result in liens on property. Companies subject to reporting in accordance with FIN 48 and FAS 5 may also have to reconsider positions with the new rules. These new rules may also affect document retention practice.

California's new "economic nexus" statute (Revenue & Taxation Code § 23101(b)) applicable to corporate franchise and income taxes in 2011, is a good example. For years beginning on or after January 1, 2011, California now defines doing business in California, the standard that subjects a corporation to taxation in California, to include not only corporations organized or commercially domiciled in the state, but also corporations that have sales in the state, including sales through an agent or an independent contractor, that exceed the lesser of $500,000 or 25% of the taxpayer's total sales. Doing business also includes holding real or tangible personal property in California of the lesser of $50,000 or 25% of total property or having payroll in California of the lesser of $50,000 or 25% of the total compensation.

Looking solely to sales in the state to establish nexus without some other presence (such as property or payroll) is a major change. The low sales threshold, particularly when combined with changes in the rules as to where sales of services and intangibles are now "located" for tax purposes, may require a review of the company's sales policies and distributor or sales contracts or creation of a mechanism to capture information about them.

Several states have adopted variations of the economic nexus approach and potential taxpayers are beginning to receive notices that may come as a surprise. For example a company that had no offices or employees in the State of Washington suddenly found itself a recipient of such a notice, possibly because it had clients in the State. It is unclear how it even came to the attention of the tax authorities in the State of Washington.

Accordingly, general counsel need to be aware of the potential exposure in these and other types of state and local taxes, not simply because of the potential tax burden which is generally the province of the financial officer, but also because of the other ramifications and effects on corporate procedures. Does this call for a review of document retention procedures? Is there a securities question with respect to reporting of presumed positions? Are there things that can be done to mitigate? Is the company possibly under the protection of Public Law 86-272, giving a safe haven for sales of tangible personal property?

The new rules also offer an opportunity for certain types of companies. For example, a state such as California permits an election to use only a sales factor rather than the usual apportionment factors, an advantage if many sales are out the state whereas property and payroll are in the state.

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