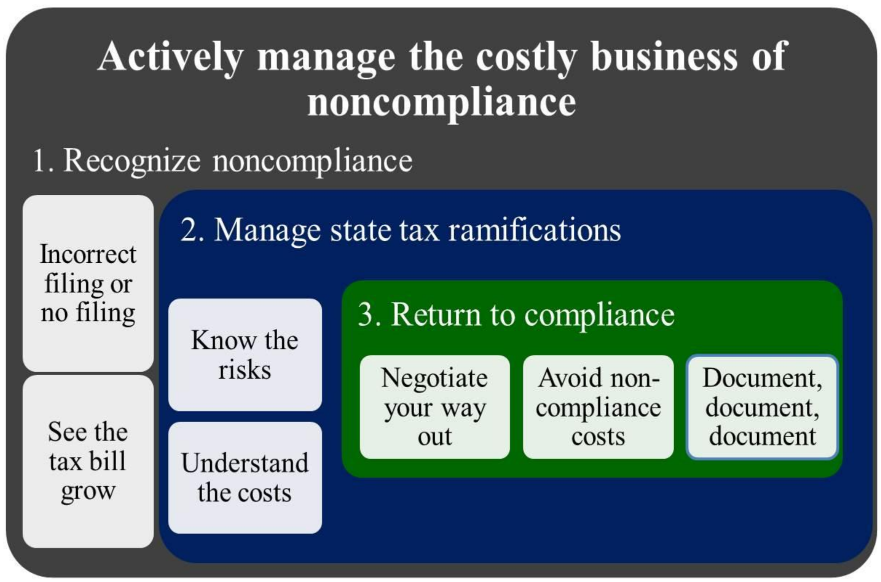
COSTLY BUSINESS OF SALES TAX AUDITS: TIPS TO LOWER RISK AND COST

By Judy Vorndran, Esq., CPA, and Meredith Smith, CPA

States yield broad powers in pursuing back taxes, penalties and fees for noncompliance. Avoid the crippling cost of noncompliance with these tips and strategies to lower risk and cost.



States yield broad powers in pursuing back taxes, penalties and fees for noncompliance. As you grow your business, avoid the crippling cost of noncompliance by knowing your obligations and preparing to meet them upfront.

How the tax bill grows

As a start-up business, you received your first round of funding. You are expending every bit of new capital to hire the best and brightest to develop your product, both within and outside your current city and state. You and your business partner attend every relevant seminar, training, conference and industry meeting possible and in doing so are pitching your product, posting signage and even signing a few contracts with customers, vendors or talent.

With little to no revenue, your company is in losses. You know your business has to file a return with the Internal Revenue Service and your home state because that is what you do for individual purposes.

Avoid these crippling costs of noncompliance:

- CPA fees to modify returns
- Unpaid tax payments, penalties and interest
- Lack of continuity, lost information, employee turnover, and system changes
- Loss of time
- Nexus study review and fees to analyze historic data
- Attorney or CPA fees during due diligence, with reduced purchase price or increased escrow to cover unpaid taxes
- CPA fees for Voluntary Disclosures

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And you think, "Great, I can do that. No tax due since I'm in losses. Filing anywhere else is not a big deal because I will not owe any tax."

Fast forward a few years. You have a relevant product or service. Your bottom line is not so much red as it is a dark gray, nearing black. You might actually be profitable, which means there is revenue. What have you done to get that revenue?

Have you visited customers? Done on-site installations? Are you still attending all the seminars, trainings, conferences and meetings you were historically? Of course! These lead generating activities have resulted in revenue and talent.

A few more years pass. You are totally killing it and people come knocking and want to buy your company. Your payday is here. But guess what? Every buyer looks at the tax filings of the target. You may think you are good because you file a return with the IRS and your home state. However, when the deal is ready to go through, you discover that the buyer wants to escrow millions of dollars (or ignore the escrow account and take it off the purchase price) for all the years you've never filed more than two income tax returns.

Because you didn't know what your state tax obligations were, you just **cost yourself millions of dollars**. In order to get the money out of escrow, you will need to pay either an accountant or an attorney to work with the jurisdictions to meet your state tax duties—not only do you owe tax, interest and perhaps penalties, but now you have CPA and attorney fees on top of that. You will get a massive bill for all your arrearage compliance, which comes due all at once rather than allowing you to spread payments out over the previous years.

State tax under reported

While this scenario is overplayed and oversimplified, it happens. And it happens a lot. There are many reasons taxpayers choose not to file a federal return, much less state returns. Even though state tax rates are uniformly lower than federal rates, and some states have no income tax at all, federal tax compliance is higher than multi-state tax compliance.

A Huffington Post article from 2013 articulated a few of the reasons for noncompliance at the federal level:

- Filing taxes is complicated;
- Fewer people think taxes are fair;
- Tax filing is time consuming and expensive; and
- Taxes are inherently unpatriotic.

From a state tax compliance perspective, people choose not to file because:

- Unique tax obligations in varying states;
- Unfamiliar with out-of-state tax requirements for similar types of taxes; and
- No systems and processes in place to understand state activities and identify an associated state tax obligation.

In addition, people fail to file returns for personal or business problems, feelings of hopelessness or fear due to an extended period of non-filing, anti-government sentiments or beliefs that the penalty will not outweigh the expense or trouble of filing.

Bad things happen if you don’t file

The United States tax system is based on voluntary compliance. If you fail to file a return with the IRS, a number of outcomes could be triggered.

- Simple mistakes happen and it is not the policy of the IRS to prosecute ordinary people. Failure to file a return, however, can be prosecuted as a criminal violation.
- If you cooperate, you are less likely to be prosecuted. Although the IRS reserves the right to recommend prosecution, it is unlikely to do so should you fail to pay your taxes so long as you voluntarily come forward before you are contacted and arrange to pay what you owe.
- If you derive your income from illegal sources, it is more likely that the IRS will recommend prosecution.
- The more blatantly fraudulent your behavior has been, the more likely the IRS is to prosecute you. For example, you would likely be prosecuted for failing to file returns year after year, despite repeated contacts by the IRS
- In order to convict you of a tax crime, the IRS does not have to prove the exact amount you owe.
- The IRS has a general policy of not enforcing the filing of returns older than six years.
- The IRS has programs in place to identify non-filers.
- The filing of a return starts the audit and collection time limits.
- If you do owe taxes, you can probably work out an installment plan to pay off your debt.
- You may be able to negotiate a settlement with the IRS, depending on your ability to pay, that will significantly diminish your overall tax debt.

- The IRS may owe you money.
- If you go to a tax professional, you will probably not have to deal directly with the IRS.
- A tax professional should be able to obtain your past W-2s, 1099s, and 1098s from the IRS if you no longer have them.
- The IRS may accept reasonable estimates of charitable contributions, medical expenses and other deductions.
- Depending on how complicated your situation and how good your record keeping is, the entire process of clearing up your non-filing status could take as little as a few weeks.

States wield authority to collect and prosecute

State collection agencies have the legal authority to collect back taxes. In addition, even though a business is in a loss for federal tax purposes, it may still have state tax obligations. States may impose minimum taxes, franchise taxes (often based on in-state assets or net equity) and gross receipts taxes (e.g. Ohio and Washington), all of which are not based on federal taxable income but can add up over time.

The laws of the state where you operate govern collection activity. Procedures generally are the same from one state to the next, and include:

- Levying your bank account with an order—no civil lawsuit or judgment is needed;
- Seizing all or part of your federal tax refund;
- Ordering the garnishment of your wages with a notice to your employer
- Placing a lien on your house or other assets, which forces you to repay the debt if you sell the property; and finally,
- Pursuing a criminal case, which could end in fines and jail time.

Voluntary disclosure reduces tax risk

With all that, why is state tax compliance not treated with the same level of urgency as federal returns? In our careers, we cannot tell you how many Voluntary Disclosure Agreements (VDAs) we've negotiated for companies big and small for significant years of noncompliance.

VDAs can mitigate a tremendous amount of tax liability, plus typically you get a waiver of penalties so why doesn't the cost of getting into compliance deter people from just staying in compliance? Why don't taxpayers understand that dealing with one state in a delinquency situation is more expensive than getting compliant in almost every state? And yet, the culture of non-compliance and the ignorance of state and local tax obligations seem to be the norm and not the exception.

Noncompliance penalties

At both the federal and state level, various types of penalties could apply for noncompliance, including:

- Failure-to-file penalty for late filing;
- Failure-to-pay penalty for paying late; and
- Freezing your bank accounts, putting a lien on your house, garnishing your future wages (including benefits like Social Security) and dipping into future tax refunds you may be entitled to.

There is often no time limit for collecting unpaid taxes and charging penalties for not filing. The government has up to six years from the date when non-filed tax return was due to criminally charge you with failing to file a return.

Maybe it is because we believe things should be simple or the same or we just hate our neighbor states? Whatever the reason, tax is often a dirty word in U.S. society, and our governments are often seen as inefficient.

Emulating a better system

Why can't we be more like Sweden? Skatteverket, the Swedish Tax Agency, is popular and considered a highly trusted public body, despite hefty taxes. Skatterverket "takes" about a third of most Swede's pay and yet are not disliked like the IRS.

A 2015 survey by market research institute TNS Sifo concluded that the Swedish Tax Agency has the third best reputation of 27 major Swedish public bodies, scoring highly for its customer service and for "contributing positively to society." "You don't have to like taxes, but most people seem confident that things are done fairly," Toivo Sjoren of TNS Sifo says.

How can we better emulate Sweden's system? First, Skatteverket does more than just collect tax. It is responsible for population registration (folkbokforing), and keeps track of many important events in every Swede's life. Similar to the U.S. Social Security number, Swedes receive a personal identity number and the agency is responsible for determining if you have chosen an acceptable name.

There are no Supermans or Dotcoms in Sweden. Skatteverket deals with your marriage by ensuring there are no impediments to marriage. It requires Swedes to keep their mailing addresses current. When you die the doctor informs the agency for your cremation or burial certificate. Maybe a little Big Brother, but apparently the Swedes think that is ok as long as there are good intentions.

Filing taxes is also as easy as a few smartphone taps. Swedes actually are not anti-tax and value a fair and well-functioning society, with decent public services and a universal safety net. The Swedish word for tax—skatt—has another meaning: treasure.

Additionally, Skatteverket is considered highly accessible and customer-friendly! Maybe we should adopt an **attitude of appreciation** rather than punishment as a method of gaining compliance, plus a good set of public relations folks to explain what state taxes are creating for citizens and people would be more willing to comply.

Better manage out-of-state tax obligations

There are a number of ways companies can better manage their out-of-state tax obligations.

- ***Know your reach***—where and what you sell, where you have property, where employees are working or traveling to, and have systems and processes in place to track all of those. It's critical to track where people and property are located and the location where revenue streams are being earned.
- ***Know your tax obligations***—before business is undertaken.
- ***Understand how revenue is generated***. Often companies like to hide behind Public Law 86-272 where your in-state solicitation presence could be protected, but that applies only for income tax purposes and the sale of tangible personal property. P.L. 86-272 does not protect the sale of services, sales taxes or franchise taxes.
- ***Document. Document. Document***. If you can support when you started visiting a state, for how long, the frequency and what you were doing, you are going to be more likely to disprove nexus if a state or buyer comes knocking.

At the end of the day, there will always be costs associated with filing tax returns. After all, someone needs to prepare returns and pay the tax.

Crippling cost of doing nothing

Operating on the "wait and see" method can cost your company dearly in the long run through:

- CPA fees to prepare returns for all the years you've ever done business at one time (paying $10,000 for ten years of returns for one state hurts a little more than paying $1,000 per year for that same state).
- Unpaid tax payments. Plus penalties. Plus interest.
- Lack of continuity, lost information, employee turnover, system changes all make data extraction and understanding your history very cumbersome, if not impossible.
- Loss of time. Pulling three to eight years of historic data is not the best and highest use of your time. This can be a full-time job--don't you already have one?
- Nexus study review and fees to have historic data analyzed.
- Pay hourly attorney or CPA fees during due diligence to try to negate the conservative escrow amount the buyer has estimated.
- Significantly reduced purchase price or increased escrow to cover your unpaid taxes.
- CPA fees to prepare a Voluntary Disclosure Agreement to release the amount of money escrowed—legally binding contract that costs a lot of money. Oh look, you still have to pay to have returns filed, pay taxes and interest.

Getting it right upfront

As long as companies understand their tax obligations before doing business in another state, taxes are rarely, if ever, prohibitive. But not knowing the obligations and finding out down the line that years of back taxes are owed can cripple a business, making the out-of-state venture not only unprofitable but dangerous to the life of the business.

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Contact Us

We look forward to hearing from you.

Judy Vorndran, Esq., CPA
Partner
720.227.0093
jvorndran@taxops.com

Meredith Smith, CPA
Senior Manager
720.227.0421
msmith@taxops.com

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