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Now More Than Ever…

As State Revenue Departments Grow Hungrier, Tax Compliance Strategies Gain Importance

These days, the risks of overlooking tax liabilities have never been higher, and the benefits are quite compelling for companies that can prove compliance. Furthermore, with states across the nation facing serious budget deficits, state revenue departments are becoming more aggressive in seeking out companies that are neglecting their tax obligations.

By Shari L. Lipski

What if there was a tool that could help you obtain credit at reduced rates, secure higher prices on portfolio sales, give you access to new lenders or make your company more valuable to prospective buyers?

What's the secret? Tax compliance.

If you think of taxes as something to minimize or even avoid, it's time to think again. Tax compliance has traditionally been viewed as a necessary evil by many companies. Today, though, the risks of overlooking tax liabilities — and the potential benefits of an active tax compliance effort — have never been higher.

For example, many lenders will not even consider providing financing to a company that cannot demonstrate compliance with applicable sales, personal property and income taxes. But some may be willing to provide a larger credit line — or reduce interest rates — to companies that can prove compliance.

Even as the rewards for tax compliance can be great, so can the risks and costs of noncompliance. Smart prospective buyers scrutinize tax payment records, and considerably discount or even entirely avoid lease portfolios or companies with questionable compliance practices.

Further, with states across the nation facing serious budget deficits, state revenue departments are becoming much more aggressive in seeking out companies that are neglecting their tax obligations. For example, according to Loren L. Chumley, commissioner of the Tennessee Department of Revenue, "The Tennessee Department of Revenue is trying to increase education and compliance through a variety of new initiatives. Last year the department increased its audit staff by 14 positions, and with those positions established a specialized franchise and excise tax unit and bolstered its discovery unit."

Only At Home

Some people incorrectly believe that taxes are due only in the state where their company is based. So they regularly collect and remit taxes to their home state — but fail to do the same in all other states where the company owns equipment or real estate, or has employees.

Working under this misconception is as risky as trying to avoid taxes entirely. The basic rule of thumb is that if a company owns an asset in a state, it must register to do business there, file the applicable documentation and pay all required taxes. Even just one dollar of income triggers a state's registration and tax reporting requirements.

Operating "Under the Radar"

While you may not think that you are avoiding taxes by paying them only in your headquarters' state, other states might disagree. In fact, thanks to more aggressive state strategies, if you do not "find" states by registering and paying taxes, the states are likely to come find you.

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"We've seen significantly increased efforts on the part of states to identify delinquent taxpayers and collect taxes," said Steve Kranz, Esq., of the Council on State Taxation (COST), a Washington, D.C.-based trade association that represents the interests of approximately 550 of the nation's largest taxpayers on state and local taxation issues. "Use of outside discovery and collection contracts is a growing phenomenon."

Technology is also playing a role by making it easier than ever for states to identify companies that should be but are not paying taxes.

The Status Quo Trap

Many companies recognize the importance of tax compliance and designate an individual or department to manage it. Such companies may assume that their initial compliance procedures will suffice for years to come.

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Unfortunately, tax regulations change rapidly, making it very easy for yesterday's exemplary compliance efforts to quickly become obsolete. Although we have not made an exact count, it is easily possible that more than 1,000 tax regulations have changed across the nation in the last five years. If a company does not carefully review every piece of paper it receives from every state and incorporate each new rule or regulation into its tax collection, reporting and record-keeping processes, the likelihood of non-compliance is very high.

For example, California recently passed legislation requiring that an environmental disposal fee be paid on certain types of monitors and other hazardous equipment sold in the state. The fee is minimal — yet the penalty for failing to pay it is $10,000 per item! How easy would it be to overlook the significance of one letter, written in "tax-speak," that announced such a change? Less than 60 days after this legislation was enacted, nearly a dozen other states proposed similar laws. Does the equipment you lease fall under one of them?

Consequences: The Sky's the Limit

Although states tend to be more lenient with companies that have made a good faith effort to comply, the consequences of non-compliance can easily add up to tens or even hundreds of thousands of dollars. Criminal charges are even possible in some cases.

Many people incorrectly believe that the statute of limitations caps these fines. However, the statute's "clock" does not start running until a company has actually filed an appropriate return with a jurisdiction for the time period in question. In other words, if your company has never registered in a state or filed taxes there, the revenue department can assess penalties, interest and taxes for as long as your company owns an asset in the state, be it three years or 30.

In some cases, penalties and interest could be significantly higher than any taxes that would originally have been due. To illustrate, a company that did not remit taxes for almost seven years was assessed more than $80,000 in penalties on the $400,000 it owed. Additionally, depending on how long the liabilities have been outstanding, interest could easily match or exceed the penalty amounts.

Non-payment of taxes may also result in liens on the leased equipment itself. In addition to cutting off the payments that are a company's lifeblood, such liens are also likely to threaten existing lines of credit and prevent a company from obtaining additional financing.

You could even owe taxes, interest and penalties on leases you sold years ago. Most funding agreements stipulate a seller's guarantee that all tax liabilities were met from the date of a lease's inception until its sale. If a state audit reveals that you did not fully meet your tax obligations when you owned the lease, the buyer is entitled to lay those taxes — plus interest and penalties — at your door.

The Bottom Line

Regardless of what you have been told about tax obligations, how you have been operating, or what taxes you have paid in your home state, state tax responsibilities are a fact of life for leasing companies.

At the most basic level, every leasing company is responsible for:

- Reporting and remitting sales, use or rental taxes in every state where it owns assets.
- Reporting and paying any required personal property or income taxes on the assets themselves, or on revenue the company earns in each state where it owns assets.
- Keeping up with changing tax regulations, rates and exemptions.

Whether tax compliance is looking more appealing because it is the law, because of potential business benefits or because of the heightened risks of non-compliance, the first step in establishing a tax compliance program is resolving three key issues:

1. Where do I have tax responsibilities? This requires determining the states in which your company has a legal presence or "nexus." Since owning an asset in a state normally triggers tax liability, this means identifying every state in which you have leases.
2. What is my responsibility for past taxes? Answering this question is more challenging because you must evaluate how each state's specific tax regulations would have applied when you owned an asset there. Given the wide variety of tax regulations among states and the speed with which they change, we strongly recommend consulting a professional who has both broad and deep knowledge of state tax regulations and leasing practices.
3. What is the "right" approach for handling past tax obligations? Once you have determined your responsibilities, it is critical to develop a strategy for approaching the pertinent states. For example, you may want to first speak with any states that might be offering tax amnesties. Or it may be advisable to start with the states in which you have the largest tax liabilities. State tax authorities may be willing to negotiate, but you will have much more bargaining power if you call the state before it comes knocking on your door.

Clarifying the scope of your tax responsibilities and implementing a plan for managing past obligations is half the battle. Now it is time to establish an active tax compliance program going forward.

Moving Ahead

There are two key elements of an ongoing tax compliance process: registration, and collecting and remitting taxes.

Registering with each state in which you are legally present is an important part of effective tax compliance. Although states use different forms, these one-time filings determine what tax documents you must file in each state and how often. You will also need a process to flag any new states in which you originate leases so you can register in them.

In addition to actually collecting the appropriate taxes from lessees and remitting them to the states, you will also need procedures to ensure that you are collecting the right type of taxes, at the right rates, and managing exemptions and incorporating frequent rule changes. With literally tens of thousands of taxing jurisdictions in the United States, an increasing number of leasing companies are choosing to automate compliance by outsourcing it to resources with the expertise and technology to ensure that compliance is managed properly.

Whether you choose to handle tax compliance internally or outsource it, deciding to take tax compliance seriously is extremely important. When you compare the impact of potentially huge penalties to the value of potential strategic benefits such as realizing higher prices on portfolio sales, it is clear that a proactive tax compliance effort is a smart business strategy — one that can more than pay for itself and possibly even make significant contributions to your bottom line. **m**

Shari L. Lipski, CLP, *is a principal at ECS Financial Services, Inc., formerly Edwin C. Sigel, Ltd., which offers state-of-the-art portfolio management, comprehensive tax compliance and expert accounting services to help equipment leasing companies succeed. Lipski represents ECS Financial Services at the Institute for Professionals in Taxation and the Streamlined Sales Tax Project, and has served as director of the Mid-America Association of Equipment Lessors. Lipski can be reached at 847-291-1333 or slipski@ecsfinancial.com.*

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