BY MATTHEW C. BOCH AND NICOLE FORD

The Problems of Dual Administration: Traps for the Unwary in the Relationship of Qualifications to Do Business and State Tax Compliance

In an era of "doing more with less," it is easy for businesses to run into compliance issues with state business qualification requirements and their state tax implications. Qualifying to transact business is typically handled by a business's legal function working with secretary of state offices. State taxes are typically handled by a company's finance or tax group working with state departments of revenue. But both types of state regulatory regimes overlap, and companies are well served to consider them together to avoid surprises down the road.

State revenue departments and secretaries of state are sharing information more effectively; corporate legal and tax departments need to do the same and work together to address state qualification and tax registration issues holistically. Failing to do so can result in surprise tax liabilities, business qualification revocations, or other penalties.

Qualifying to do business—which every state requires of foreign corporations transacting business within the state—generally consists of submitting an application that details fundamental information about the business, such as its name, state of incorporation, and purposes for which it was organized, as well as paying a fee to the office charged with oversight of business organizations in the state. Once qualified, the state recognizes the legal existence of the foreign entity and allows it to do business in the state as if it had been formed domestically. A secretary of state's office typically handles qualification to do business in a bureaucracy entirely distinct from the department of revenue handling tax registration and compliance.

Following business qualification rules is critical, as transacting business in a state without being qualified to do so may expose the business to a number of penalties. There are fines, for example a corporation that transacts business in California without first qualifying is subject to a monetary penalty of $20 per day.[1] A foreign corporation that is required to qualify, but which has not done so, is often prohibited from pursuing any action in state court until it qualifies and pays any outstanding fees and penalties.[2] Some states even allow an injunction to be brought against a foreign corporation that is transacting business in the state without authority,[3] which could result in a substantial disruption of business operations.

Generally, qualifying to do business requirements apply at a higher threshold of in-state activity than that which is necessary to subject a foreign company to state tax nexus. This threshold varies among states and may be poorly defined.

Illinois is a typical example. Its statutory scheme imposes a qualification requirement on any foreign corporation transacting business within the state,[4] and provides a list of activities that do *not* constitute transacting business, such as maintaining, defending, or settling any proceeding, owning (without more) real or personal property, selling through independent contractors, and soliciting or obtaining orders if the orders require acceptance outside of Illinois before they become contracts.[5]

Some of these activities, for example owning property, would typically create state tax nexus. Illinois never actually defines, by statute, what the phrase "transacting business" means, but Illinois courts have held that, for foreign corporations, transacting business means being engaged in a person's ordinary business activities exceeding isolated instances in the state.[6]

While the legal standards and state administrators differ, qualification requirements and tax requirements share common factual underpinnings, and companies should evaluate nexus and qualification requirements together. While companies may currently use paralegals to conduct qualification studies and tax managers to conduct nexus studies without each consulting the other, economies of scale favor considering qualification to do business and state tax nexus together, as many of the relevant facts are the same: office locations, employees, property, temporary visits, etc.

Systematically considering qualification to do business and tax nexus requirements together also provides assurance that a company is meeting its regulatory requirements and taking consistent, prin-

At the time of this writing, MATTHEW C. BOCH was a partner in the Chicago office of the law firm of McDermott Will & Emery LLP. He currently is a member of the Little Rock, Arkansas, law firm of Dover Dixon Horne PLLC. NICOLE FORD is an associate in the Dallas office of McDermott Will & Emery LLP.

cipled positions in its state registrations. A business does not want a situation where a paralegal has gone ahead and qualified to do business while the tax department is taking a no-nexus position.

The consequences of uncoordinated qualifications and registrations can be highly problematic. If a company *does* qualify to transact business, this may provide the state a means to tax a corporation for business it does within that state. First, as a practical matter qualifying to do business can put the company on the state department of revenue's tax audit radar, particularly as states continue to update their information technology systems. More troublingly, a company may find the qualification used as evidence of nexus, both in the context of franchise taxes that are imposed on having the privilege of transacting business and more generally in the world of income or other business activity taxes.

A business that has qualified may owe tax even if no business has actually been done in the state.[7] However, Public Law 86-272 protection should not be affected and should protect many sellers of tangible personal property.[8] Additionally, for sales and use taxes where the physical presence rule of *Quill* applies, the taxpayer has strong arguments that qualification to do business does not establish the requisite physical presence nexus to require collection of tax.

When leaving a state, the company must withdraw for both tax and qualification purposes, which can involve filing final tax return forms with the department of revenue *and* filing the appropriate termination documents with the secretary of state. Terminating the legal existence of a business within the state often involves obtaining a tax clearance from the revenue department.[9]

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Failure to properly withdraw with a completed tax clearance can mean that a business is still considered to be qualified to do business, with all the attendant filing and tax obligations still in effect—and often going unmet because the company assumes that it has been withdrawn. Such an omission can result in significant and unexpected taxes and penalties.

Going in the opposite direction, tax issues can also jeopardize qualification to do business. Some states revoke qualification if a company fails to pay its taxes. Once revoked, a company will generally need to pay all outstanding taxes, along with penalties and interest, and file an application for reinstatement accompanied by a tax clearance letter to resume doing business in the state.[10] A company's tax group may not enjoy the attendant scrutiny as the legal group becomes involved in restoring the qualification.

Strategies for fixing qualification and registration problems can also differ, particularly when a business has missed its obligations for long periods of time. Almost all state tax authorities have voluntary disclosure programs that allow taxpayers who come forward of their own volition to limit their lookback periods and avoid penalties (and sometimes interest).

Many secretary of state offices do not have these types of programs, meaning that taxpayers trying to come forward and fix things may face more expense from secretary of state qualification fees and penalties than from back taxes, particularly in the case of small- and medium-sized businesses. The magnitude of these fees and penalties can create a perverse incentive to stay "under the radar" instead of coming forward.

In conclusion, given the overlap between state qualification requirements and tax requirements, a company conducting a multistate business should carefully evaluate whether its activities may cause it to be subject to state tax nexus, secretary of state registration requirements, or both. Coordinating registration and compliance is critical to avoiding the surprises and costs that can result if a company fails to address these issues together. ■

1 Cal. Corp. Code § 2203.

2 *See, e.g.*, N.Y. Bus. Corp. Law § 1312(a); 805 Ill. Comp. Stat. 5/13.70(a); D.C. Code § 29-105.02(b).

3 *See, e.g.*, Ariz. Rev. Stat. Ann. § 10-1502(F).

4 805 Ill. Comp. Stat. 5/13.05, 5/13.15.

5 805 Ill. Comp. Stat. 5/13.75.

6 *Wenige-Epperson, Inc. v. Jet Lite Products, Inc.*, 328 N.E.2d 665 (Ill. App. Ct. 1975).

7 *See, e.g.*, N.J. Admin. Code § 18:7-1.8(a), Example 3.

8 *See* Hellerstein and Hellerstein, State Taxation ¶ 6.27 (3d ed. 2014).

9 *See, e.g.*, Tex. Bus. Orgs. Code Ann. § 9.011(c).

10 *See, e.g.*, Tex. Bus. Orgs. Code Ann. § 9.104(d).