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Hot State Tax Audit Topics

TEI Houston Tax School - State and Local Tax Workshop

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February 3, 2014

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Learning Objectives

- Learn about recent state tax enforcement trends.
- Learn about best practices to prepare for audits.
- Identify some of the hottest state tax audit topics.
- Analyze cases that illustrate these audit topics.
- Understand what are likely to be hot future state tax audit topics.

Agenda

- Enforcement Trends
- Audit Defense – Best Practices
- Corporate Income Tax Audit Topics
- Sales Tax Audit Topics
- Residency Audits
- Unclaimed Property Audits
- False Claims Act / Qui Tam Litigation
- Questions / Solutions / Experiences

ENFORCEMENT TRENDS AND AUDIT BEST PRACTICES

Enforcement Trends

- Information requests

- Auditors are using information obtained from other state agencies.
- Auditors are demanding more information from taxpayers.

- Auditor approaches

- Auditors are placing high burdens on the taxpayer to prove that the taxpayer's position is correct.
- Auditors are involving attorneys and senior officials earlier in the audit process.

Enforcement Trends Continued

- Increased sophistication
 - States are hiring capable people and are sharing ideas.
- Imposing considerable penalties and interest
 - 20% understatement penalties;
 - Amnesty penalties;
 - High interest rates;
 - Interest cannot be waived;
 - Strict liability penalties.

Audit Best Practices

- Plan ahead (pre-audit).
- Contemporary documentation for major transactions and significant state tax positions is very important.
 - Summarize all the factual issues in a memo now (difficult to piece together the facts later).
 - Develop legal analysis explaining why the position was taken and citing to the relevant authorities.
 - Will be better positioned to handle a future audit.
- If there is an analysis/explanation in the file, much better positioned for an audit that is likely years away.
- Involve a state tax litigator early for analysis/suggestions.

Audit Best Practices Continued

- Initial meetings with auditor
 - Establish scope of audit.
 - To the extent possible, set deadlines/schedule.
- Document conversations with the auditor
- Know when to approach management
 - Many states have seen turnover and/or senior-level people leaving for early retirement.
 - Can be useful to involve auditor supervisors if dealing with junior auditors.
 - May be helpful to contact state legal department for a meeting to get a sense of how management is viewing the issue.

CORPORATE INCOME TAX AUDIT TOPICS – NEXUS

Economic Nexus

- Overview

- What is economic nexus?
- Two types of economic nexus statutes.

- Taxpayer due process victories

- Scioto (Oklahoma)
- ConAgra (West Virginia)

- Recent United States Supreme Court Due Process Cases

- *McIntyre*
- *Daimler AG v. Bauman*

- Pendulum swinging in favor of taxpayers?

Unitary Nexus

- Economic dependency.
- Background on concept and cases.
 - W.L. Gore case (Maryland)
 - Harley Davidson case (California)
- Are these cases confusing and/or conflating two different concepts?

Ownership of a Partnership Interest and Nexus

- Most states take the position that the mere ownership of a partnership interest is enough to create nexus.
 - Hot audit issue.
 - Companies are passively investing in partnerships and may not file where the partnership is located.
- What about MLPs?
- 99/1 Partnership cases.
 - Utelcom (LA)
 - BIS LP and Village Supermarket of Pennsylvania (NJ)

Nexus and Web Servers

- Bloomberg BNA 2013 Survey results relating to web servers:
 - 26 states said that nexus exists based on leasing space on an internet server located in the state.
 - 24 states said nexus exists based on storing data on a server located in the state.
 - 12 states said nexus exists based on using a web-hosting provider with a server in the state.
- Texas web hosting ruling (repealed).
- Should this be sufficient to establish nexus?

CORPORATE INCOME TAX AUDIT TOPICS – MTC ELECTION

MTC Election Litigation and Audits

- Overview of Issue
- Current Litigation
 - Gillette (CA)
 - IBM (MI)
 - Anheuser-Busch (MI)
 - Health Net (Oregon)
 - Graphic Packaging (TX)

MTC Election Litigation and Audits

- Likely will continue to be a significant issue in 2014.
 - More court decisions.
 - More states will repeal the Compact.
 - What will this mean for the MTC audit program?
- What to do?
 - File refund claims?
 - Use defensively on audit?
- Potential for United States Supreme Court review?
 - Split?
 - Broad constitutional issue.

CORPORATE INCOME TAX AUDIT TOPICS – COMBINED REPORTING

Combination and Decombination

- Discretionary combination states
 - Indiana;
 - North Carolina;
 - South Carolina;
 - New York.
- In stark contrast to the past, auditors are increasingly looking to “decombine” companies
 - IT USA (NY)
 - Knowledge Learning Center (NY)

Combination and Decombination Continued

- Unitary or non-unitary?
 - For MUCR states.
 - Different business lines?
- Another area where it can be helpful to document position.
 - In states with discretionary combined reporting, and/or high exposure states, develop analysis that explains why certain entities are in the group or out of the group.

Combination and Decombination Continued

- Potential future hot combination audit topics.
 - Inclusion of entities in “tax haven” countries in combined returns.
 - DC combined reporting (unincorporated business entity combination issues, who is in, who is out of the combined return).

CORPORATE INCOME TAX AUDIT ISSUES— RECEIPTS FACTOR

COP – Overview and Audits

- Although market based sourcing is the trend, many states still have COP statutes for sales of services.
- Different approaches:
 - Greater of COP.
 - Majority COP (rare).
 - Proportionate COP.
- Applying COP: what is the income-producing activity?
 - *AT&T* cases (Oregon and Massachusetts).
- Study can be helpful in the event of an audit.

Alternative Apportionment

- Audit trend: states are applying COP statutes to reach market-based sourcing results.
 - Equifax (Mississippi)
 - Vodafone (Tennessee)
 - Rent-A-Center (Indiana)
- Burdens.
- Alternative apportionment should be used in special situations only.

Market Based Sourcing States – Audit Issues

- Determining where is the market for services.
 - Where is the benefit received?
 - Where is a service delivered?
- Billing address may be easiest approach to administer, but is it correct?

CORPORATE INCOME TAX AUDIT
ISSUES – SHAM TRANSACTION
DOCTRINE AND RESTRUCTURINGS

Application of Sham Transaction Doctrine to Restructurings

- Allied Domecq (MA)
 - Parent company intentionally obtained a Massachusetts taxable presence (nexus) so that its subsidiary could use its NOLs.
 - Did this by transferring employees in Massachusetts from subsidiary to parent.
 - MA DOR: no legitimate non-tax reasons for transferring the employees. Argued it was a sham. MA ATB agreed.
- Troubling implication: restructurings could be deemed shams and tax benefits denied.
- See also Knowledge Learning Centers (NY)

CORPORATE INCOME TAX AUDIT ISSUES – FEDERAL RARS

Federal RARs

- Federal RARs background.
- State statutes require that federal RARs be reported within a certain number of days.
- SOL opened for a certain period of time.
- Some states limit opening of SOL to federal RAR only; other states attempt to look at other issues that may be unrelated.
- Is it appropriate for states to use an RAR as an excuse to examine issues wholly unrelated to the RAR?
- Lewis v. Reynolds doctrine (U.S. Supreme Court).

SALE OF A BUSINESS – TAX BASE

Sale of a Business – Exclude Gain from Tax Base

- Business / nonbusiness
 - Anything nonbusiness any more?
- Constitutional arguments?
 - Allied-Signal (U.S. Supreme Court)
 - Meadwestvaco (U.S. Supreme Court)
- Planning ahead and documentation important for audits.
- May still be viable in some cases.

MTC AUDIT PROGRAM

MTC Audit Program

- Overview of how the program works.
 - Usually working with one auditor.
 - Auditor makes recommendations.
 - States can choose to accept or reject auditor's recommendations.
- General focus is limited to several big ticket issues.
 - Nexus
 - Unitary/non-unitary
 - Business/non-business

SALES / USE TAX AUDIT TOPICS – ELECTRONIC COMMERCE AND LOCAL SOURCING

Affiliate Nexus - Remote Vendors

- Affiliate nexus.
 - States are looking at relationships between in-state parties and out-of-state vendors that are not filing and are looking for any basis to establish nexus.
 - Global CFO example. Common trademarks.
- Are the states going too far?
 - What about Miller Brothers (United States Supreme Court)?

Click-through Nexus and Notice Litigation

- Fact pattern and legislation
 - Amazon laws
 - Notice litigation
- Cases
 - Amazon and Overstock (NY)
 - Performance Marketing Association (IL)
 - Direct Marketing Association (CO)

Services/Software Purchased over the Internet

- Subject to sales tax?
 - Is it canned software / TPP?
 - Is it a taxable service?
 - Is it data processing?
 - Is it an information service?
- State to state approach.
 - Remember that this is a sales tax issue an a use tax issue.
- Negotiating contracts with vendors.

Local Sourcing Issue

- Overview

- In some states (for example, Illinois) the locality sales tax rate can vary from 0% to 4%. Sourcing the sale is important.
- A few states source based on local selling location. Accordingly, may be possible to move selling location to locality with a 0% local rate.

- Hartney Oil (IL) case

- Background
- What is next in Illinois?
- How about elsewhere?

RESIDENCY AUDITS

Residency

- People are moving from high-tax states like California and New York and New Jersey to states that do not impose an income tax (like Florida or Nevada or Texas or Washington).
- Individuals want to retain some connection to the old state (for example, a home or apartment) while no longer paying income tax as a resident.
- Audit flag.
- Residency audits can be personal and contentious.

Residency Audits – Continued

- Sale of a business fact pattern.
 - Business is operated in a high tax state.
 - Owner moves to no-tax state.
 - Sells business shortly after moving to high-tax state.
 - Subject to tax by high-tax state?
- Hot audit issue with many variations on this theme.
- Similar corporate tax issue.
 - Depreciation deductions claimed by corporation.
 - Corporation moves out of state and then is sold.

Unclaimed Property Audits

Unclaimed Property Audits

- Overview

- Multi-state audits typically performed by third-party audit firms (Kelmar, ACS, Verus).
- Securities audits are very popular now.
- Lookback period (1980s).
- Estimation techniques.
- Delaware taking recent heat in the press.

- Best practices

- Engage law firm and accounting firm that specializes in this area.

False Claims Act / Whistleblower / Qui Tam Audits

False Claims Act / Whistleblowers / Qui Tam

- Approximately 30 jurisdictions have False Claims Act statutes.
 - Many statutes explicitly bar tax suits.
 - Some states bar only income tax matters.
- Illinois experience.
 - Mechanics of filing a claim.
 - Internet and shipping and handling cases.
- New York experience.
 - Background on statute.
 - Mechanics of filing a claim.

False Claims Act / Whistleblowers / Qui Tam

- Standard usually something less than fraud.
 - “Knowingly” or “willingly”.
- Anyone can be a whistleblower.
 - Member of a taxpayer’s tax department.
 - Member of an accounting firm performing due diligence.
 - Customer that receives a receipt or invoice that does not impose sales tax.
- Problems: (1) case goes to a regular court where the judges do not have tax expertise; (2) attorneys working on case may not have tax expertise; and (3) cases filed often do not involve fraud – law may be unclear.
- Will more states hop on the FCA bandwagon?

Questions/Solutions/Experiences to
Relate?