Tax and Accounting Center™

Source: Daily Tax Report: News Archive > 2011 > March > 03/03/2011 > BNA Insights > Dispute Resolution: Nonlitigated Resolutions of Multistate Tax Disputes: Three Case Studies Show How Taxpayers, States Can Find Common Ground

42 DTR J-1

Dispute Resolution

Litigating tax disputes can be expensive, and the costs are not always measured in amounts paid to outside counsel. A tax case can consume valuable internal resources as a company works with counsel to answer discovery, prepare for depositions, hearings, or trial, and, quite often, prepare or respond to an appeal. Many disputes, however, can be resolved without resorting to a lawsuit or filing an administrative protest. In this article, author David Fruchtman, of Horwood Marcus & Berk Chartered, uses three case studies to explain how taxpayers can effectively apply alternative approaches to resolving disputes.

Dispute Resolution

Nonlitigated Resolutions of Multistate Tax Disputes: Three Case Studies Show How Taxpayers, States Can Find Common Ground

By David A. Fruchtman

David A. Fruchtman is of counsel with Horwood Marcus & Berk Chartered. He can be reached at dfruchtman@hmblaw.com.

At some point, almost every multistate business will find itself pregnant with a potential state tax dispute.

The potential dispute is often based on the business's strategic planning but it can also be the result of a simple tax reporting mistake. Other times, the dispute is based on a new or different interpretation of the law than the states' revenue departments decide to take. As businesses always prefer to conduct their affairs unimpeded by state revenue departments, many businesses will continue to rely on their unproven interpretation, implicitly or explicitly intending to defend themselves in litigation if their position is challenged. [1]

[1] In this article "litigation" refers to all contested tax matters, whether in an administrative proceeding or in a court of law. While the case studies below involve potential assessments, the advantages of avoiding litigation extend to refund claims as well.

However, when the interpretation involves a repeat transaction—for example, the taxability for sales and use tax purposes of the sale of the business's goods or services—the financial risk of an ever-rising exposure for uncollected and/or unpaid taxes can overwhelm even strongly held beliefs in nontaxability.

Further, state information-sharing arrangements can cause an isolated dispute to spread to other tax jurisdictions. This is even more likely when a legal decision is rendered, whether the case was won or lost, as a published decision in one jurisdiction can lead to audits in other jurisdictions.

In such circumstances, many businesses will desire a quicker, quieter, and more predictable resolution than is obtainable in litigation. This article describes some methods practitioners can use to resolve tax disputes without litigation.

Reasons to Avoid Litigation

> *"When will mankind be convinced and agree to settle their difficulties by arbitration?"*
>
> *Benjamin Franklin*

Litigation is expensive, sometimes very expensive. At its most obvious, tax litigation requires paying lawyers at hourly rates that reflect their expertise in two areas—litigation and the technicalities of taxation. In most circumstances, one lawyer is not proficient in both areas, meaning that the business has to pay at least two lawyers. This is especially true when litigation enters the discovery phase and at all points thereafter, which also is a time when expert witness fees might be incurred.

Litigation also creates substantial internal costs. These include the value of time spent strategizing with counsel, preparing timelines and factual backgrounds, reviewing draft documents, answering discovery, preparing for and being deposed, preparing for hearing or trial, attending the hearing or trial, and assisting on appeals (whether as the appellant or appellee).

Litigation involves nonfinancial costs as well, starting with the emotional energy it absorbs as a case winds it way through its life cycle. In addition, many businesses do not want any publicity regarding their tax situation, a position that is jeopardized when a dispute enters the courts. Furthermore, negative publicity from a loss can create unpleasant effects lasting well after the state revenue department deposits the business's check for tax, interest, and penalties. In some circumstances, this can be true even from a litigated win. [2]

---

[2] The author received a first-rate education in this when he was tax counsel in a dispute involving a large, newly constructed, industrial facility. Efforts to resolve the matter through negotiation were checked at every step by litigious counsel for the tax authority. With no alternative, the dispute entered the courthouse and led to the issuance of a temporary restraining order against the authority. This, in turn, led to an expedited discovery schedule and a successful conclusion to the matter, with the possibility of further gains. However, rather than press its advantage, the business worked again and again to reach a resolution with the tax authority and its counsel. The vice president of finances explained that the bigger picture needs of the business mandated these repeated attempts at resolution. As he explained, "We are here for the long term. I need a good relationship with the community so that my trucks will have access to the facility, for future zoning issues, and for other future business needs."

Adding the risks of adverse decisions to these external and internal costs should make any vice president of taxes hesitant to begin a formal dispute. It is therefore important that these officers are able to tell other senior management that they made their best effort at resolving

a dispute before it matured into a case. This is especially true when confronting litigation in multiple jurisdictions.

Three Case Studies

Three case studies drawn from real world experiences demonstrate how these situations might arise and will be used below to demonstrate how the situations can be addressed. Each of these circumstances could have resulted in litigation:

- **Case Study No. 1.** Corporation A is a start-up business selling a new product of uncertain sales taxability. Due to internal confusion, Corporation A began collecting sales taxes even though it was not registered to do so with any state. It never remitted the collected taxes. Corporation A never believed that the money belonged to it and never took the collected funds into revenue. Rather, the company's bookkeeper continued to receive collected taxes, retaining the money in a separate bank account while debiting a contra-asset account on the company's financial records. These practices quickly became routine within Corporation A, and were not reviewed for several years.

- **Case Study No. 2.** Corporation B is a large business with a sophisticated tax department. The corporation performed one of several variations of a cutting-edge service. The service was sold across the country but did not fit cleanly into any category of service that is subject to sales tax. Corporation B and other businesses in this industry were aware that, as a general principle, services are not subject to state sales taxes. Therefore, the businesses (including Corporation B) consistently treated such sales as nontaxable. However, when several jurisdictions contended that a variant of the service is taxable, Corporation B's senior management became concerned that its service would be challenged as well. The corporation's management therefore instructed its tax department to eliminate the company's historic exposure for unpaid sales taxes and to treat the sales as taxable going forward.

- **Case Study No. 3.** Limited Liability Company C is a small Canadian business that was beginning its initial entry into the U.S. market. In making its entry, its entire focus was on increasing its sales. LLC C did not know whether its sales were taxable but, given its small size and insubstantial revenue stream, it did not engage a tax adviser to evaluate the taxability of its sales across the country. Rather, it did not collect any sales taxes on its sales and did not file income tax returns outside of the state of its U.S. headquarters. Over several years, LLC C's sales grew, as did the size of its sales tax exposures. (The company had losses for income tax purposes.)

Attitude Comes First

The first step toward reaching a nonlitigated resolution sounds obvious but in truth needs to be addressed directly: The business's tax managers and outside counsel must want to reach a nonlitigated resolution. They must become comfortable with the reality that a nonlitigated resolution will cost something.

Attitude also refers to the approaches taken with state revenue departments. There is no one correct approach, and most lawyers use different approaches depending on the situation. But central to all approaches is respect for the intellect and authority of revenue department personnel.

This by no means suggests being a supplicant. Both in-house tax professionals and outside tax advisers are paid to be advocates and are expected always to have the business's best interest in mind. But that best interest might require abandoning attempts to reach the lowest "dollars and cents" resolution on the discrete issue at hand and instead working with state personnel

to find the best solution for both sides. This requires the attorney to consider the state's interest as well as his client's interest. [3]

---

[3] Of course, outside counsel can do this only to the extent that he or she knows the state's interests. Revenue departments, like business clients, might have incentives or limitations affecting the resolutions they are prepared to consider. But unlike the attorney's clients, revenue departments will not disclose these to the client's lawyer. For example, the author attempted to negotiate a resolution of an income tax dispute involving the application of a technical area of a state's law. Efforts to address this directly were made difficult by the state official's apparent inability to appreciate the "apples to oranges" approach she was requiring. The author sought a fresh perspective from one of his colleagues as to the cause of the state official's confusion, but with no better success. The author subsequently learned that other taxpayers were reaching the same obstacle with the state. The problem, therefore, was not an inability to explain the issue; nor did the problem arise from the state official's inability to appreciate the issue. Rather, the state had adopted a policy that it chose not to disclose and that no amount of reasoning from a taxpayer's advocate was going to change. In such a circumstance, the lawyer must explore other routes to a nonlitigated resolution.

Attitude also involves creativity and flexibility in exploring possible mixes of solutions. Multijurisdictional issues in particular are likely to require more than one type of solution.

The good news here is that many senior personnel within state revenue departments are prepared to take the same approach to building bridges. However, it is important to recall that the taxpayer bears the burden of designing possible solutions.

Many Paths to Reaching A Nonlitigated Resolution

State tax practitioners must be aware of the many formal and informal methods of dispute resolution. This article will describe many of these through a discussion of the case studies. (Minor factual adjustments have been made to protect client confidentiality.)

Case Study No. 1

In Case Study No. 1, Corporation A had stumbled into one of the true cardinal sins of state taxation. In states across the country, collecting but knowingly failing to remit sales or use taxes can be treated as a crime. State revenue departments publicize, for in terrorum effect, successful prosecutions of proprietors who engage in such conduct.

So, while Corporation A's failure to remit taxes was accidental, it was not expected that the states were going to accept that claim easily, nor was it expected that the states would excuse Corporation A's conduct without imposing substantial penalties.

Corporation A's first step was to stop the improper conduct. This is a direct application of the "Law of Holes," which teaches that "the first step in getting out a hole is to stop digging." Here that was a two-step process: First, Corporation A had to stop collecting taxes without making remittances. Second, Corporation A had to disgorge its improperly retained taxes. Thus, its choices were to either:

- register with states immediately and continue to collect and remit taxes while determining whether its sales are taxable; or

- stop collecting tax and work quickly to remit taxes to the states, and then to determine whether the sales are taxable.

The downside of the former approach was substantial, as the corporation would have had to

identify itself and leave itself largely unprotected from the states' punishments. The downside of the latter approach was that, until Corporation A received guidance from counsel or the states, it was implicitly treating its sales as being nontaxable, and accepting upon itself a liability for state sales taxes that it otherwise could have collected from its customers.

Corporation A chose the latter approach. It therefore halted its sales tax collections while its counsel contacted the states to make remittances on a taxpayer anonymous basis.

The first step was to identify states having open or upcoming amnesty programs. Participation in these generally is an excellent solution to the problem of improperly collected taxes. The programs, however, come with at least one notable downside—namely, the information-sharing agreements the amnesty states have with other jurisdictions create a risk that the business's identity will be disclosed to those other jurisdictions.

As protection against such information-sharing agreements, taxpayers sometimes request assurances from the amnesty jurisdiction that the jurisdiction will not offer its name to other taxing bodies, an assurance that is sometimes provided. A taxpayer receiving such an assurance should have the time it needs to contact the other states before the states contact it.

This, too, highlights an important strategy for a business in Corporation A's predicament: Counsel should initiate contact with the relevant state and local jurisdictions as quickly as possible so that the business is making the first communication (i.e., a voluntary communication) about the problem.

At the same time that the amnesty states were being contacted, Corporation A needed to contact the remaining states. Because so many states were involved, counsel sought a method of streamlining the remittance process. Counsel therefore contacted the Multistate Tax Commission (MTC), and proposed an atypical application of the MTC's multistate voluntary disclosure program.

Counsel should initiate contact with the relevant state and local jurisdictions as quickly as possible so that the business is making the first communication about the problem.

The desired arrangement was atypical because, unlike a voluntary disclosure in which the taxpayer's identity is always disclosed when an agreement is reached, here the business's identity would not be disclosed. Further, there would be no signed voluntary disclosure agreement and payment of back taxes would be made by checks issued by the law firm.

The arrangement involved several telephone discussions with a representative of the MTC, followed by a letter from counsel explaining the circumstances that led to the business's collection but nonremittance of sales taxes. The letter also contained an offer to anonymously remit taxes and interest through the business's counsel. The letter, while addressed to the MTC representative, was actually intended for the MTC's participating states.

Corporation A did not request anything further of the states except that they accept the money. It was aware of the risk that a state might contact it later, in which case the state would not have a record of a remittance from the corporation. However, the corporation concluded that proving remittance should be possible by demonstrating that its counsel remitted the taxes and, in all events, continued to believe that the downside of disclosing its identity was greater than the downside of remaining anonymous.

The arrangement with the MTC worked as desired. Some states required additional attention, usually a need to talk through what was being offered to become comfortable that accepting the funds would not cause the state to forfeit any rights. However, in short order Corporation A had remitted its collected taxes to the MTC states as well as to the amnesty states.

Other states had to be contacted directly. Once the taxes were remitted, Corporation A and its counsel thereafter obtained state determinations regarding the taxability of the corporation's sales (taxable in some states; nontaxable in others).

Case Study No. 2

Case Study No. 2 presents the most straightforward circumstances of the three case studies. Corporation B made an informed and defensible decision not to collect sales tax on its sales. It maintained that position in good faith for between six and 15 years, but when several states challenged a competitor's sales tax treatment of a similar service, Corporation B decided to take a new approach.

Rather than risk incurring the litigation costs described above, Corporation B sought to become compliant with the states' and local tax jurisdictions' desired treatments. To do so, it began a national voluntary disclosure process, offering through counsel to begin collecting the jurisdictions' taxes in exchange for the jurisdictions' agreement not to assess taxes for prior periods.

Local jurisdictions were generally more challenging because of difficulty identifying the parties who could agree to such arrangements.

Most of the states understood the issue and responded quickly. Several states agreed with the taxpayer that there was a good argument that its sales were nontaxable, and accepted prospective treatment. Another state agreed with the taxpayer that its sales probably were not taxable and therefore refused to enter into a prospective voluntary agreement. Instead, it referred the matter to its tax policy group, which issued a letter ruling holding that the sales were not taxable. Most other states required payment of two to three years' back taxes plus interest, with waiver of penalties.

Local jurisdictions were generally more challenging because of difficulty identifying the parties who could agree to such arrangements. Even after that person was identified, there remained the sometimes formidable task of persuading them that voluntary disclosure agreements were an accepted practice. Taxpayers needing to negotiate voluntary disclosure agreements with local tax authorities should anticipate that the process will take longer than the same negotiation would take with a state.

In the end, Corporation B's legal bills were a fraction of its contemporaries' (which continued to climb) and its sales tax payments made in resolving its multistate issue were much less than its potential exposure. And, after the conclusion of its compliance project, it no longer had an exposure for uncollected and unpaid back taxes, while its customers were continuing to purchase its service despite the imposition of sales taxes.

Case Study No. 3

LLC C presents an additional factor to the discussion above—namely, continuing uncertainty regarding the characterization of its product as being a type of manufacturing equipment. If the product was manufacturing equipment, many states would treat the sale of the product as nontaxable. But if the product was not manufacturing equipment, many states would treat the sale as taxable unless another exemption applied to the sale.

While LLC C was beyond the start-up phase of its U.S. activities, it was in no position to pay for rulings in 40, 30, or even 20 states. It therefore identified the six states where the amount of its sales were greatest and began the process of requesting rulings from those states. It received a very quick but negative response from one state. The state provided a formal appeal process but, before LLC C filed an appeal, it determined that several of its other selected states used the same definition as the first state.

LLC C thereafter determined that the relevant definition was contained in the Streamlined

Sales and Use Tax Agreement. In such a situation, where the issue involves the interpretation of a sales tax definition, the taxpayer can petition the Streamlined Sales Tax Governing Board for a ruling. If the governing board agrees to issue the ruling, its determination must be followed by all member states and all states waiting to become members of the governing board. [4] At the time that LLC C sought its ruling, there were more than 20 such states.

[4] A state that does not follow the determination can be held noncompliant and required to come into compliance or risk a variety of sanctions.

Requesting a ruling from the governing board meant—if the board exercised its discretion to consider the issue—that LLC C could obtain one ruling applicable to more than 20 states. The board agreed to consider the issue on an expedited basis. Several months later, LLC C received its desired ruling, which was binding on all member and associated states, including the state that had previously issued an adverse ruling. [5]

[5] Notably, the receipt of a requested definition does not assure that the item will be nontaxable when sold. The Streamlined Sales and Use Tax Agreement is designed to provide uniform sales tax definitions; however, participating states are able to treat the sale of any item as being taxable or nontaxable as they deem appropriate. In LLC C's circumstance, some 16 states provided exempt or other favorable tax treatments to the sale of the item that was the subject of LLC C's inquiry.

Of the remaining states, there were a handful meriting individualized attention; in the remainder, LLC C conducted its best possible analysis of taxability, erring on the side of collecting tax.

When it concluded the project, LLC C established the sales taxability of its product without unduly exposing itself to assessments for uncollected taxes and without spending any resources on contested appeals or litigation.

Income Tax Concerns

In the author's experience, multistate income tax issues that can be resolved in a consolidated effort are less common than sales tax issues.

By way of example, while issues involving tax presence, anti-passive investment company legislation (denying deductions for interest and royalty payments to affiliates), and income sourcing often affect the taxpayer in more than one state, they are fact-specific and generally must be resolved on a state-by-state basis. Fortunately, many of the same approaches described above are available for taxpayers seeking nonlitigated resolutions.

Moreover, if the taxpayer and its counsel are motivated, the complexity of these issues also presents settlement opportunities.

An important step is to determine whether the issue affects one period or several periods. Where several periods are affected, there is often an opportunity for splitting the open periods on a principled basis so that both the taxpayer and the state can claim victory.

Even at the audit level, where auditors often claim an inability to reach negotiated resolutions, experience has shown that auditors often are willing to involve senior personnel to conclude complex issues if doing so will result in an agreed audit.

When All Else Fails

"Even peace may be purchased at too high a price."

The analysis above describes the application of a variety of approaches for avoiding litigation. There are other methods as well. But by far, the

Benjamin Franklin

most important element to reaching a nonlitigated resolution is an attitude that makes working with tax jurisdictions a high priority.

The second most important is having the creativity to find a solution that is acceptable to both parties, recognizing that other elements of a settlement might be as important as dollars paid.

However, there remain circumstances where settlement is not possible. This can occur when the tax jurisdiction wants an answer to a question and uses the taxpayer's circumstance as a test case. And it can occur when a tax jurisdiction simply rejects the taxpayer's positions and refuses settlement or is willing to settle only on terms the taxpayer finds unacceptable.

Here, the only nonlitigated resolution is to accede to the tax jurisdiction's demands. For any of a number of reasons the taxpayer might decline to do so, in which case litigation is necessary. When this occurs, the tax manager, having attempted several approaches to achieving a nonlitigated resolution, should report those efforts to management.

Thus informed, management will know that the expense of litigation was unavoidable and also will be aware of the approaches to resolution already attempted. This latter consideration is important, as settlement is possible at every stage of litigation.

Conclusion

Experience has shown that state and local tax litigation is expensive and often unnecessary. Taxpayers that are willing to use a mix of available resources can often eliminate multistate tax exposures without incurring penalties and without exposing their business to unwanted publicity.

Likewise, taxpayers that are prepared to work cooperatively with state and local revenue departments will often find the departments receptive to the overtures, so that a mutually satisfactory resolution is obtainable.

Essential to all of these efforts is in-house personnel and tax counsel who are committed to reaching such nonlitigated resolutions.

Contact us at http://www.bna.com/contact/index.html or call 1-800-372-1033

ISSN 1947-3923

Copyright © 2011, The Bureau of National Affairs, Inc. Reproduction or redistribution, in whole or in part, and in any form, without express written permission, is prohibited except as permitted by the BNA Copyright Policy. http://www.bna.com/corp/index.html#V