

Exploring Proactive State Resolutions—VDAs, Amnesty and Alternative Apportionment

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Agenda

Introduction – Proactive Resolution of Potential Tax Disputes

Voluntary Disclosure Agreements

Amnesty

Alternative Apportionment

Other Proactive Resolution Techniques

Voluntary Disclosure Agreements and Amnesty

Why VDAs? In part, Voluntary Disclosure Agreements are a byproduct of states:

- Aggressively targeting companies with multi-state operations
- Looser nexus laws (economic nexus, click-through nexus)
- Increased use of computer research tools to locate companies that previously may have gone unnoticed
- Increased use of penalties as a revenue-raising device

Why Amnesty? Amnesty is in part a legislative response to the success of VDAs, as state legislators often seek to “plug” budgets with revenue produced from amnesty offered to taxpayers.

VDAs - Reminders

What are Voluntary Disclosure Agreements? Generally, VDAs are contracts (similar to audit agreements) entered into by states and taxpayers. The agreements generally resolve the fact that a taxpayer has either consciously or unconsciously taken a no-nexus, non-filing position in a state.

How are VDA opportunities/issues identified? VDAs often arise as a consequence of:

- Tax Provision Analysis
- Nexus Studies
- Mergers & Acquisitions Due Diligence
- Change in Management/CFO

VDAs - Reminders

- **What types of taxes can VDAs cover?** Generally, all taxes are open for VDAs - e.g., income, sales/use, property, franchise, unclaimed property.
- **What time periods are covered by a VDA?** Many states employ either 3 or 4 year look back periods. In the case of income tax, this permits taxpayers to amend returns in other states for open periods to adjust apportionment and "pay for" some of the liability created as a result of the VDA.
- **What benefit does the taxpayer get?** By voluntarily coming forward, the taxpayer's liability is limited to the look back period, even if nexus/tax liability existed for prior periods.

VDAs - Reminders

How does the process work?

- Most states have a designated unit/official that handles voluntary disclosure agreements.
- The process is usually anonymous at first—an attorney or CPA writes a letter describing the company’s activities in the state and explains its filing position. Some states have application forms.
- VDAs are generally only open to companies that are not being audited and have not been contacted by a state (i.e. nexus questionnaire). Some impose “no previous registration” requirements.
- In addition to resolving past years, typical VDAs require returns to be filed on a going-forward basis (as long as the entity has nexus in the state).

VDAs - Reminders

How does the process work?

- After both sides have reached a preliminary agreement, the taxpayer must disclose its identity and file returns.
- Push for “spreadsheet” returns if possible in order to reduce compliance time.
- Because of information-sharing agreements among states, be sure to push for confidentiality provisions in the VDA.
- Make sure you qualify for the program! The worst result is when poor due diligence reveals that there has been a “contact” letter with a company, but the company has already disclosed its identity. Now the state knows who you are but you are not entitled to the program’s protection!

VDAAs – Emerging Issues

- **VDAAs and “Economic Nexus”**: VDAAs have become more important in recent years as nexus standards have morphed from bright line “physical presence” to more nebulous “economic presence” standards.
- **VDAAs and “No Nexus”**: VDAAs generally cannot be used to get confirmation of a no nexus position. States mostly require that the VDA process result in tax liability and a tax payment. Instead, consider a state’s declaratory ruling procedure.

VDA – Emerging Issues

- **VDA and Market-based Sourcing (MBS):** VDAs will be even more critical as more states adopt market-based sourcing. While MBS does not change nexus standards, it does affect the amount of income sourced to a state. A taxpayer previously may have chosen not to file because minor tax liability would ensue. Due to MBS, more significant tax liabilities may arise, but a taxpayer may want to seal off prior liabilities through the use of a VDA, particularly for states that are aggressive on penalty assertion.
- **VDA and Flow-through Entities:** Due to the prevalence of flow-through entities in today's business structures, even more issues arise with the reporting and withholding obligations of flow-through entities.

VDAs – Emerging Issues

- **VDAs and Customer Contact/Recordkeeping:** For sales tax VDAs, it may be important to contact customers to get sales for resale exemption certificates and/or understand sales tax paid in chain transactions.
- **VDAs and Expansion into a State:** VDAs can be utilized when expansion is being considered into a state. A taxpayer may have chosen not to file/was unaware of nexus, but has now chosen to expand into the state. In addition to the normal VDA process, taxpayers should consider involving the government relations/lobbying group to see if more favorable terms can be negotiated.

VDA – Emerging Issues

- **VDA and M&A Activity:** Because the VDA process often occurs as a result of corporate acquisitions, make sure that the transaction documents (e.g., reps and warranties, tax sharing agreements, indemnifications, escrow amounts, etc.) adequately describe the responsibilities and liabilities for VDA resolution, particularly because such issues can drag beyond closing, and because states have the ability to audit the years under agreement.

VDAs – State Variations

Remember that even though there are many similarities from state to state, differences are key. Examples of state variations are:

- Texas - must fill out nexus questionnaire
- Alabama - all tax types must be addressed in initial application for VDA
- California - 6 year look back period

MTC – National Nexus Program

- Instead of approaching each state individually, the Multistate Tax Commission (MTC) National Nexus Program allows taxpayers with problems in multiple states to resolve all at once through the Multistate Tax Commission.
- Goals of the National Nexus Program? Taxpayer Compliance, State Cooperation, Education, and Fair and Consistent Enforcement.
- Separate applications are required for each state but includes common components that can be replicated.
- The MTC representative coordinates the responses from the states and may potentially serve to push back on specific questions on state law.

MTC – National Nexus Program

- The MTC process can take longer but can be effective in resolving situations where nexus has been exceeded in a number of states.
- 40 state recent example - 30 done by MTC program and 10 by direct contact with the states. Both successful. Going state by state would have swamped the resources of the company.
- The MTC program is anonymous through the acceptance by the state of the proposed terms - this is an advantage compared to some state specific programs.

Amnesty on the Rise

- Becoming more popular again as states look to balance budgets.
- New York—Voluntary Disclosure and Compliance Program
- Louisiana 2014 Program
 - La. Program was all tax, no penalties, and 50% interest
- Massachusetts 2014 Program
 - It was an “invitation only” amnesty
 - CIT not included
 - Can’t participate for another 10 years
 - Could be in appeals process

VDAs versus Amnesty

- Voluntary Disclosure Agreements are often preferable to use of amnesty
 - Amnesty is often not anonymous
 - Amnesty periods are often very short and can require a tremendous amount of work in order to comply (i.e. 10/1-11/30)
 - Amnesty often does not limit the time period - returns and payments are required for all periods
 - Amnesty may not provide relief from all amounts of penalties
 - Amnesty generally provides little opportunity to negotiate

Amnesty – Final Thoughts

- Amnesty or Coercion?
- In enacting its 2003 amnesty, Illinois also included an amnesty interest penalty, which provided that companies that did not take advantage of the amnesty would be subject to 200% interest on the liability.
- The Illinois Supreme Court upheld this penalty (including that it did not violate the Due Process Clause), even though the liability arose as a result of a Federal RAR that occurred after the amnesty. See Met Life v. Hamer, 990 N.E. 2d 1144 (2013)
- These types of provisions make it critical for Tax Departments to stay on top of amnesty developments across the country and to strongly consider VDAs to clean up old tax liabilities.

Alternative Apportionment – UDITPA Section 18 Standard

Sec. 18 of the Uniform Division of Income for Tax Purposes Act (UDITPA) provides for variations in the apportionment formula when the standard formula does not fairly represent the extent of the taxpayer's business activity in a state.

Sec. 18 relief includes:

- separate accounting;
- exclusion of any one or more of the factors;
- the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the state; or
- the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Alternative Apportionment – Situations Where Section 18 Is Used

- **Individual Taxpayer Situations:** UDITPA Section 18 has generally been used by *states* in audits or litigation to modify a taxpayer's use of a standard apportionment formula. Much less frequently, taxpayers have successfully asserted Section 18 in audits or litigation to change the standard apportionment formula.
- **Taxpayer Petitions:** Taxpayers have had occasional success in petitioning states to approve in advance modifications to the standard apportionment rule, although it is relatively still uncommon for states to agree to this.
- **Special Apportionment Regulations:** UDITPA Section 18 is the basis for states' adoption of various special apportionment regulations, most of which are focused on specific industries. In these situations, the states are determining that the standard rules do not fairly apportion the income of broad groups of taxpayers and those rules should be modified.

Alternative Apportionment – Scope of Section 18 Is Limited to Apportionment

Section 18:

- Only addresses whether the standard formula is a fair representation of the taxpayer's activities in the state.
- Does not address questions about the size of the tax base to which the formula is applied.
- The size of the tax base should already be decided before issues of alternative apportionment are addressed.

Alternative Apportionment – Procedure for Seeking Relief

- Taxpayers may petition states for alternative apportionment relief.
- Valid petition requires a clear statement of grounds upon which relief is being sought and proposed alternative.
- Consider whether particular format or procedure is required in the particular state (e.g., no specific format is mandated in California).

Case study: Procedure for Seeking Alternative Apportionment in California

- Pre-filing development of facts, technical arguments and alternative methodologies
- Initial vetting of proposed petition with FTB
- Prepare and vet draft petition
- Finalize petition based on staff feedback
- Interaction with assigned FTB counsel
- Consider modifications of final approval letter

Case study: FTB Process in Handling Alternative Apportionment Petition

- Initial review by assigned FTB counsel
- Factual development, if needed
- Staff recommendation
- Committee meeting – Approval or Denial
- Appeal from adverse determination to 3-member Franchise Tax Board
- Can raise issue later, *e.g.*, settlement

Alternative Apportionment - Procedure for Seeking Relief

When may a petition be filed?

- Before filing return
- During an audit
- During a protest
- Within a claim for refund
- Assert position on return?
 - See FTB Notice 2004-5 (taxpayer required to petition FTB in advance for approval of method in order to avoid accuracy-related penalties).

When is it too late? Appeal/Litigation:

- After protest: Failure to exhaust administrative remedies may be an issue.
- After claim for refund: If SOL closed, state may assert that taxpayer cannot raise this as a new issue on claim for refund.

Fair Reflection of Income – Basis for Alternative Apportionment

Section 18 applies if “the allocation and apportionment provisions...do not fairly represent the extent of the taxpayer’s business activity in this state.”

“Distortion” is often used by states, as well as taxpayers, as a shorthand to describe the lack of fair reflection of income.

Alternative Apportionment – What is Distortion?

“Distortion is not proved by comparing results. To determine whether there is distortion, the analysis must focus on the relationship between the apportionment factors and the taxpayer’s business activity providing the taxable income...Measuring income by factors which are unrelated to the production of income can result in unfair apportionment”.

Crocker Equipment Leasing, Inc. v. Department of Revenue,
12 OTR 16, 1991 Ore. Tax LEXIS 6 (1991)

Alternative Apportionment – How Do You Prove Distortion?

What is qualitative distortion?

- Activities in question are qualitatively different from the taxpayer's principal business activities.

What is quantitative distortion?

- The quantitative differences between the standard apportionment formula and the proposed alternative must be significant.

Qualitative Distortion

- Key question is determining what are the taxpayer's principal business activities.
- Compare/contrast California case law (treasury function activities ancillary to principal business activities) with *Merrill Lynch* (broker dealer activities a fundamental segment of taxpayer's financial services business)

Quantitative Distortion

- Must look at the entire formula, not just one factor.
- Is there a significant aspect of the business which is not properly reflected in the formula?
- Are the profit margins of various aspects of the business disparate?
- How significant are the differences between the income assigned to the state under the standard formula and the proposed alternative?
- No bright line percentages.

Burden of Proof: Who has burden?

Generally, the burden of proof to apply alternative apportionment under Section 18 is on the party seeking alternative apportionment. The moving party must show:

- That standard apportionment does not fairly represent the extent of the taxpayer's activities in the state (i.e. distortion), and
- The proposed alternative is reasonable.

Some states may require the moving party to show that the proposed alternative method **more fairly** represents the taxpayer's business activity in the state.

Burden of Proof: Statutory

The burden that must be carried is the statutory burden and not the burden to show that the constitution has been violated, which is generally a much higher standard that,

- " 'the income attributed to that State is in fact "out of all appropriate proportions to the business transacted ... in that State," [citation], or
- has "led to a grossly distorted result," [citation].' "

Standard of Proof

The California Supreme Court held that the moving party "has the burden of proving by clear and convincing evidence" that

(1) "the approximation provided by the standard formula is not a fair representation," and

(2) the "proposed alternative is reasonable."

Note: In South Carolina, the courts have held that the standard is a preponderance of the evidence. (*CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*)

Burden of Proof: Special Regulations

Generally, taxpayer can rely on special industry and other regulations promulgated under Section 18

- Normally, would not need to prove distortion.

Can Regulations Promulgated Under Section 18 Be Modified By Section 18 Itself?

- In theory, it is possible to modify Section 18 apportionment regulations in individual taxpayer situations.
- Same burden for proving need for Section 18 relief arguably applies.
- As a practical matter, states may resist modifying special apportionment rules except in truly unique situations.

Other Proactive Resolution Techniques

- Rulings
- Informal Guidance
- Issue Resolution Agreements
- Statutory Relief Provisions (water's edge, change in accounting method, etc.)
- Regulation Process
- Interactions with Governmental Affairs and Similar Professionals

Questions?

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