

# Practical Approaches for Addressing State Tax Audits

**E. Scott Ewing**  
Deloitte Tax LLP

**Craig B. Fields**  
Morrison & Foerster LLP

**Brian O'Leary**  
NBCUniversal Media, LLC



# Agenda

- Proactive preparations for a tax audit
- Practical examination considerations
- The administrative appeals process
- Formal and informal settlement alternatives

# Proactive preparations for a tax audit

# Proactive preparations for a tax audit – the controversy before the controversy

It is never too early. So what can I do?

- Document return positions
  - Gather facts, technical authority and other supporting documentation
  - Prepare audit defense tools, e.g., technical memos and potential exposure calculations
  - Should be done pre-return filing
  - Limits the potential loss of institutional knowledge
- Develop a controversy specific database
  - Maintain audit defense tools
  - Requires ongoing maintenance and defined file retention parameters

# Proactive preparations for a tax audit – the controversy before the controversy

- Perform a self audit first
  - Know your company's tax return positions
  - Know your company's sampling issues
    - Be prepared for a sampling agreement request
- Prepare an issue chart
- Quantify issue by year
- Allocate resources based on risk-weighted return on investment

# Proactive preparations for a tax audit – the controversy before the controversy

Various forms of advanced/concurrent written guidance are available in many states to avoid or mitigate the controversy's advancement

- Petitions/requests for alternative apportionment (“Section 18 Relief”)
- Chief Counsel Rulings
- Closing Agreements
- Legal Rulings
- Technical Advice/Audit Memoranda
- Voluntary Disclosure Agreement (VDA) Programs

Observation: Some states are more active than other states in handling and granting alternative apportionment petitions and other advanced guidance.

# Proactive preparations for a tax audit – the controversy before the controversy

Organize and manage your company's audit file

Closely monitor all information provided to states

- Retain copies of all correspondence with the Department (e.g., IDRs, Responses, etc.)
- Cross-referencing IDRs will help to avoid duplicative production and inconsistent responses

# Proactive preparations for a tax audit – the controversy before the controversy

## Other considerations

- Is this a continuing or discrete issue?
- Are the issues present in earlier or later years?
- Other risks – media, legal, business, financial
- Accounting (reserve) considerations



# Practical examination considerations

# Practical examination considerations

## The opening conference

- Create an audit plan with the auditor
- Seek to develop a timeline – even if speculative
- Expected timing of closing the audit – set a goal with the auditor
- Discuss plan for executing SOL waivers if needed/expected
- Agree on extension periods, number of extensions for IDRs, etc.
- Agree on manner in which communication will occur

# Practical examination considerations

## Assess the auditor(s)

- Internal

- Educational background
- How long have they been with the state?
- How long have they been auditing the particular tax?
- Is the particular tax their specialty?
- Interpretative abilities

- External

- Experience in industry
- Experience at competitors
- Experience at customers
- Experience at suppliers

Will those experiences be translated to your situation?

# Practical examination considerations

## Internal – auditor’s view inside the “file”

- Expectations of information exchange during audit
  - Data
  - Reports
    - Electronic
    - Hard copy “back up”
  - Analysis

## External – what can the auditor be expected to review beyond the information provided by the company?

- Search engines
- Company website
- Competitor websites
- Wikipedia

# Practical examination considerations

During the audit: assess, strategize and adjust

- Assess the overall experience
- Strategize as to how to work with the auditor
  - Plan
  - Lead
  - Respond
- Adjust to the actual observed experience as the audit continues
- Understand the State's case
  - Confer with the auditor throughout the course of the audit as a way to learn the State's issues and theories

## Other methods

- Colleagues
- Service providers

# Practical examination considerations

## During the audit

- Understand the State's case
  - Confer with the auditor throughout the course of the audit as a way to learn the State's issues and theories
- Other methods
  - Colleague
  - Service providers

# Practical examination considerations

During the audit: be realistic

Consider if resolution is possible at the audit level

- Likelihood for *factual* disagreement
  - Is it a factual issue that can be resolved through the production of documentation?
  - What third-party documentation is obtainable?
- Likelihood for *technical* disagreement
- Auditors generally cannot act contrary to state administrative regulations or state administrative guidance
  - Auditor will not be able to make decisions regarding the constitutionality of state tax laws or regulations

# Practical examination considerations

Once you have the auditor's assessment(s)

- Know your assessment to defend against it
- Is the communication from the auditor
  - an actual audit assessment
  - an initial proposed assessment
  - a jeopardy assessment, or
  - an arbitrary assessment?
- The type of assessment will dictate how you react and address



# Practical examination considerations

Know your assessment to strategically address it

- Realistically evaluate the likelihood of success on the various issues
- Understand the multistate implications of the tax position. Consider the audit period and any open periods
- Determine whether the issue is significant enough to
  - appeal/protest
  - litigate
  - seek settlement

# The administrative appeals process

# The appeals process

Know your company's appeal options

Varies state-by-state and can include one or more of the following:

- Informal pre-assessment opportunity to address issues prior to assessment
- Administrative hearing within the Department before payment of an assessment
- Judicial review of the matter (specialized tax court or general jurisdiction)

# The appeals process

## Assess the environment

- Does the Department want to litigate the issue?
- Does the Department or auditor have a particular interest in the issue?
- Does the issue have political implications?
- Potential for re-audit

# The appeals process

## The written appeal (or protest)

### Generally establishes “the record”

- May not be able to raise new arguments after administrative appeal
- Should all possible arguments be raised?
- Do secondary arguments weaken the primary argument?

### Should be written in a way that someone new to the audit can understand quickly and easily

- The appeals representative may not “study” the file
- The file may be poorly organized or documented by the auditor

# The appeals process

## Department of Revenue representative

- Does the representative have the authority to consider other factors?
  - How much latitude is given?
  - What weight is given to other factors?
- Does the representative have the authority to enter into a closing agreement?
  - What signatures are needed to get the agreement?
- What are the limitations on the representative's ability to waive interest and/or penalties?

# The appeals process

Has this issue been settled in other states?

- Does the company have a multistate strategy for dealing with identical or similar positions?
  - How will this settlement impact other states?
- For states already settled how does this compare to previous settlements?
- Impact of state information sharing

# Formal and informal settlement alternatives



# Informal inquiries or communication

- Discussion with state representatives
- Discussion with auditors and supervisors
- Information requests
- Informal ruling requests
- Discussion with Taxpayer Rights Advocate

Generally common to all of the above – Informal guidance may not support a filing position or avoid penalties

# Formal and informal settlement alternatives

When should settlement be raised?

- During the course of the audit?
  - Minor or secondary issues (smaller dollar amount, nonrecurring issue)
    - Attempt to settle with auditor (some states may allow based on merits only)
    - Can be used to “trade” for other more important or material issues
  - Significant issues (large dollar amount, recurring issue)
    - Depending on strength of position, attempt to discuss with audit supervisor/manager
  - Consider whether company’s position seems weak if settlement is raised during audit

# Formal and informal settlement alternatives

What is the fair settlement amount?

- Percentage of assessment?
- Dollar amount?
- Hybrid?

# Formal and informal settlement alternatives

Settlement/Closing agreement “may” address:

- Issues settled
- Methodologies used
- Handling of issue in future periods and audits
  - Sometimes difficult to secure
- Adjustments to net operating losses and credits
- Residual effect on related members

# Contact Information

E. Scott Ewing

[eeswing@deloitte.com](mailto:eeswing@deloitte.com)

Craig B. Fields

[cfields@mofo.com](mailto:cfields@mofo.com)

Brian O'Leary

[brian.oleary@nbcuni.com](mailto:brian.oleary@nbcuni.com)

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