Overcoming the Challenges of State Tax Audit Management

TEI Audits & Appeals Seminar

May 3, 2017

Jeff Friedman
Partner

Carley Roberts
Partner
Agenda

- Start on the Right Foot
- Audit Management
  - Audit Workplans
  - Managing Documentation and Information Provided
- Protecting Privileges
  - Attorney-Client Privilege
  - Work-Product Doctrine
- Special Audit Management Considerations
  - Statute of Limitations Waivers
  - Multistate Issues
  - Coordinating with Federal Tax Audits
Start on the Right Foot
Start on the Right Foot
Opening Meeting

– Schedule “kick-off” meeting with auditor
  • Be aware of any agency regulations or notices that address how audits are to be conducted

– Discuss scope of audit, expected time frame, expected information needed

– Discuss lines of communication with auditor

– Discuss whether the audit will be a field or desk audit
  • What makes the most sense?

– Discuss where and how information will be provided to auditor
  • At client site? Representative’s site? Mail/email? Third-party drop site?

– Be clear whether auditor may take or copy information viewed on-site; consider privacy issues (e.g., subscriber bills, corporate minutes or agreements with proprietary content, etc.)
Start on the Right Foot
Rules of Engagement

— **Be nice**
  - A “make life difficult” strategy doesn’t work and is expensive
  - Always be respectful to auditors; they often progress to supervisors

— **Be helpful**
  - Work with the auditor to get all the factual information correct
  - Make on-site visit productive by preparing materials in advance
  - Control the information and tell the story to the Department

— **Be firm**
  - Make it clear if there is certain information that you won’t/cannot provide
  - Explain privilege and work product protection; waiver consequences
  - Stand firm on strong legal positions

— **Be present**
  - In-person meeting with the Department can pay dividends in arriving at an understanding and closing an audit
Audit Management
Audit Management
Audit Workplan

- Company should always establish an audit workplan with auditor at the beginning of an audit
  - Creates predictability for both company and state
  - Eliminates any uncertainty regarding the scope and direction of the audit
  - Reduces risk of delayed or stalled audits
  - Company should maintain a standard audit workplan, but the audit workplan should be tailored or modified for each audit
  - Smaller or less contentious audits may not necessitate a complete workplan
Audit Management
Audit Workplan (cont’d)

- Audit workplan should address:
  - Scope of audit
    - Companies being reviewed
    - Types of tax subject to audit
    - Issues being audited
    - Tax years being reviewed
  - Timeline for completion
  - Process for review of documentation
    - On-site or off-site?
    - Do some reviews need to be supervised?
    - Will auditor be permitted to make copies?
  - Documentation to be reviewed
    - Sample size
Audit Management
Managing Documentation and Information Provided

- Keep track of documentation/information provided to auditor
  - Use an audit log
  - Retain copies of all correspondence with the Department (e.g., IDRs, responses, etc.); consider bates labels
  - Don’t be put at a disadvantage by not having all the information you provided to the Department
  - Avoid duplicative production and inconsistent responses by cross-referencing IDRs
Audit Management
Managing Documentation and Information Provided (cont’d)

– Verbal IDRs
  • Avoid them. Either ask the auditor to put the request in writing (best choice) or you put it in writing to the auditor stating what you understand is being requested and when the information and/or documentation needs to be provided

– Focus inquiries
  • Restrict responses to overly extensive requests

– Consider whether documentation/information should be offered when not requested to support positions
  • Failure to provide documentation/evidence during the audit may preclude reliance on evidence at a later point
    • *United Parcel Services General Services Co. v. Dir., Div. of Taxation*, 25 N.J. Tax 1 (N.J. Tax Ct. 2009): Taxpayer’s right to appeal was limited to whether the auditor’s determination was reasonable in light of the information available at the time of audit
  • Consider whether information or documentation should be shared proactively to shape your position on a given issue

– Balance compliance with protection of taxpayer rights
Protecting Privileges
Protecting Privileges

Overview

— **Before any requests are made by the auditor:**
  - Explain company policies to auditor (e.g., we never give copies of corporate minutes, we never provide master agreements with vendors because of proprietary content, etc.)
  - Understand what communications or documents are protected at early stages of audit to avoid waiver of privilege and protections
  - Constantly reassess and anticipate requests that are likely to be made

— **Aggressive auditors will ask for everything and anything without regard to protections from disclosure**
  - Carefully review all documentation to ensure that privileged documents are not provided to auditor
  - Disclosure may waive privilege and protections
  - All privileged documents should be labeled as “Privileged & Confidential”
  - Nature of privilege should be carefully documented in case challenged by auditor
  - Don’t summarize issues discussed in privilege documents
Protecting Privileges
Attorney-Client Privilege

— Protects confidential communications between an attorney and a client primarily related to providing legal advice:
  • Where legal advice of any kind is sought
  • From a professional legal adviser in his capacity as such
  • Communications relating to that purpose
  • Made in confidence
  • By the client
  • Are permanently protected
  • From disclosure by the client or the legal adviser
  • Except if the protection is waived

— Absolute protection against disclosure – endures indefinitely

— Waiver: Communication is voluntarily disclosed to any third party
Protecting Privileges
Attorney-Client Privilege (cont’d)

— Communication
  • Oral or in writing or wordless actions (client nods “yes”)

— Made in confidence
  • Client intends it be treated in confidence
  • Often presumed confidential if made in course of professional relationship
  • Presence of or disclosure to third party who has no legitimate reasons for being involved may destroy privilege
    • Further interests of client? (Joint client, etc.) or reasonably necessary to accomplish purpose? (Interpreters, secretaries, assistants, accountants, etc.)
Protecting Privileges
Attorney-Client Privilege (cont’d)

— Made to an attorney
  • Licensed (or believed to be licensed)

— From a client
  • Includes corporations and other associations
  • Joint defense agreements (multiple parties with aligned interest but represented by different attorneys to communicate with each other)

— Seeking or obtaining legal advice
  • Acting as business adviser (not legal counselor) not protected
Protecting Privileges
Federal Work-Product Doctrine

Rule of evidence codified in the Federal Rules of Civil Procedure § 26(b)
- Applies to all communications dealing with the same subject matter

A document is privileged work product if:
- Documents and tangible things;
- Prepared “in anticipation of” litigation or for trial; and
- By or for another party or by or for that other party’s representative

Work-product doctrine is a qualified protection
- Can be overcome by showing substantial need for the protected documents, and an inability to otherwise obtain the information contained in the documents without undue hardship

Waiver: Only disclosing material in a way inconsistent with keeping it from an adversary waives work product protection
Protecting Privileges
Federal Work-Product Doctrine (cont’d)

– Intent is to allow counsel to prepare their cases for trial in privacy

– Typically a privilege for attorney’s workpapers, notes, memoranda and reports gathered or prepared by counsel in anticipation of litigation or for trial
  • But includes non-litigation matters in some states, e.g., California

– Covers work product of non-attorney working under the direction of an attorney

– Generally not absolute protection
  • Attorney’s “brain work” absolutely protected
  • Rest typically “conditional”

– May cover reports, opinions and knowledge of an expert, unless it is expected the expert will testify at trial
Special Audit Management Considerations
Special Audit Management Considerations
Statute of Limitations Waivers

Know the current SOL and whether that SOL is impacted (e.g., lengthened) by other SOLs for the same tax periods (e.g., Federal SOL). Are you open for both assessments and refunds?

What if auditor asks for an extension of the SOL? Weigh the benefits and risks:

<table>
<thead>
<tr>
<th>Providing SOL Waiver</th>
<th>Benefits</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• May allow auditor time to complete audit&lt;br&gt; • Limits risk of jeopardy assessment&lt;br&gt; • May improve cooperation by state if other issues occur</td>
<td>• May result in an inefficient audit or unnecessary delays&lt;br&gt; • May increase risk that auditor finds potential exposures</td>
</tr>
<tr>
<td>Not Providing SOL Waiver</td>
<td>• Forces auditor to be more efficient in audit&lt;br&gt; • May result in shorter audits&lt;br&gt; • May reduce risk that auditor finds any potential exposures</td>
<td>• May result in jeopardy assessment&lt;br&gt; • State may be less cooperative on other issues</td>
</tr>
</tbody>
</table>

Ensure waivers address both assessments and refunds
Length of the waiver
Special Audit Management Considerations
Multistate Issues

– Develop a multistate strategy for dealing with multistate issues; imperative to address early in the audit process
  • Prioritize jurisdictions

– State information sharing has increased the likelihood of multiple state assessments

– MTC is auditing and submitting for assessment tax challenges on a multistate basis

– Proactive management of multistate tax challenges is crucial to the effective resolution of multistate tax issues
Special Audit Management Considerations
Coordinating with Federal Tax Audits

- Federal tax audit group and state tax audit group should consult regarding treatment of key issues at federal and state levels and examine reasons for inconsistencies
  - State tax audits may be negatively impacted by responses provided to IRS
  - Oversimplified responses can be problematic for state tax purposes
  - Characterization or resolution of a transaction may not have federal tax consequences but may create state tax issues
Special Audit Management Problems
Coordinating with Federal Tax Audits (cont’d)

- Federal tax audit group and state tax audit group should consult regarding disclosure of information and documentation
  - Disclosure to IRS will waive attorney-client privilege protection
  - Perception that state tax audits are conducted after the federal tax audit is not always accurate
  - State tax audit may proceed in advance of federal tax audit because of state initiatives to accelerate revenue, including:
    - Voluntary compliance programs
    - Aggressive audit schedules
  - State tax audit group may not be aware of potential federal tax issues/consequences
Special Audit Management Problems
Coordinating with Federal Tax Audits (cont’d)

- State tax audit group should consult with federal tax audit group to preserve federal tax positions
  - State tax audit group must coordinate review of responses that potentially affect the federal treatment

- Defending state tax issues during a state audit
  - Preserve federal tax positions while defending a state tax audit
  - Characterization of a transaction at the state level may be inconsistent with the federal treatment

- Defending federal tax issues during a state audit
  - State tax authorities have become more aggressive about auditing federal tax positions (auditing above-the-line)
  - Coordinate the defense of such a challenge with the federal tax audit group
Questions?
Connect with us!
Download the Eversheds Sutherland SALT Shaker app today

Be sure to also submit your pet through our app to be featured as Pet of the Month!

- Apple App Store
- Google Play
- Amazon Appstore

@ESsaltlaw