Pitching the Perfect Game: Best Practices for Administrative Procedures

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Pre-Audit: The Pre-Game Warm-Up
“If you don’t know where you are going, you might wind up someplace else.”—Yogi Berra

I. Organize Your Team for Future Audits and Appeals

A. Some transactions or tax positions are more likely to create controversy than others.

1. Asset sales, entity acquisitions and dispositions, internal restructurings, intracompany transactions, and positions contrary to established practice by the tax authority are especially vulnerable to attack.

2. Anticipate audit risk and prepare accordingly.

   a. Transactions completed today could be subject to scrutiny many years later. For example, in Allied Domecq Spirits and Wines USA, Inc v. Comm’r of Revenue, Nos. C282807, C293684, & C297779 (Mass. App. Tax Bd., May 22, 2013), the Board considered the tax implications of an internal restructuring transaction undertaken by the taxpayer seventeen years prior.

3. Prepare necessary workpapers, compliance memoranda, and opinions contemporaneously with the undertaking of a transaction or the taking of a tax return filing position.

   a. Assume that transactional documents may (unless privileged) need to be produced during audit or during an administrative review or appeal.

      (i) Protect the privilege with internal or external counsel with appropriate safeguards when using non-attorneys.

   b. Consider how an auditor or a state attorney may interpret statements within such documents many years later. For example, in Allied Domecq, the Board focused on the fact that the taxpayer’s tax department had prepared memos stating that the internal restructuring was a “state tax planning project,” and there would be “no impact to the management results” from the transaction.

4. Align with appropriate parties within the organization to have support for the position and avoid surprises.
a. Review with reporting function to ensure proper provision and FIN 48.

b. Review with in-house tax controversy team to shore up support for position.

c. Review with business stakeholders affected by return position.

5. Preserve employee knowledge.

a. Over time, employees will inevitably leave a company or change positions, and may take valuable details regarding a transaction or a tax filing position with them.

b. Consider maintaining regularly updated lists of employees within the company who have knowledge regarding a transaction/tax filing position; before employees leave the company, consider whether the employee has any knowledge that can be preserved.

c. Although it is often expedient to have tax department personnel attest to the facts in tax cases, it can be beneficial to have non-tax personnel who can address the business purposes behind the transaction. *See Kimberly-Clark Corp. v. Comm’r of Revenue*, 981 N.E.2d 208 (Mass. App. Ct.) *app. denied*, 464 Mass. 1107 (2013) (Board focused on the fact that the taxpayer only called tax department employees as witnesses in concluding that transactions were tax motivated), and a recent highly controversial non-unitary position ultimately supported by tax authority principally as a result of direct questioning of internal fact witnesses.

(i) It is useful to identify the individuals in a company that understand the business and its transactions, and maintain a good working relationship with those individuals.

6. Review the company’s general document retention policy, and make sure it prevents necessary documentation from being lost or unnecessary documentation being retained.

a. Ensure that company policy requires sufficient retention of transactional documentation and information regarding restructurings.

b. If employees maintain personal “working files” relating to asset sales, acquisitions and dispositions, and/or restructuring transactions, establish procedures to make sure copies of such files are retained in the company’s general files, e.g., Outlook PSTs.
(i) Control use of non-secure server locations, especially "cloud" services, e.g., Gmail, and Evernotes.

c. Maintain procedures to ensure that documents can be found even after custodians leave the company, and consider index services, e.g., SharePoint, Adobe Acrobat.

d. Ensure that only final documents are retained, not drafts.

e. Take action to preserve any privileges that may exist and be sure that the attorney-client privilege is not inadvertently waived by sharing protected documents with those outside of the attorney-client relationship (which might, depending on the circumstances, include accounting firms and outside consultants).

B. Auditors can and do “Google” and many look at a company’s public documents (SEC filings, corporate press releases, etc.) and publicly available documents (news articles, litigation, etc). Such information may result in a company’s selection for audit or determine the issues addressed or the positions taken on audit.

1. Encourage personnel preparing public documents to have drafts reviewed by the company’s tax department prior to publication.

2. Educate personnel involved in drafting documents that may become public or be produced on audit of terms that may be misconstrued.

3. Keep communications and government relations teams informed as to what information should or should not be disclosed in communications to third parties, e.g., large expansion in a state when the use of partnerships or other devices to not result in a corresponding large increase in the apportionment factor.

II. Specific Issues to Consider for Certain Transactions

A. Dispositions of assets/entities.

1. Why is the disposition being made? And why now?

   a. See Hercules decisions for an example of where the purpose behind a transaction was well documented (Hercules Inc. v. Dep’t of Revenue, 753 N.E.2d 418 (Ill. Ct. App. 2001); Hercules Inc. v. Comm’r of Revenue, 575 N.W.2d 111 (Minn. 1998); Hercules, Inc. v. Comptroller of the Treasury, 716 A.2d 276 (Md. 1998)).

2. What was the company’s relationship with the entity/assets in the years prior to the disposition? Was the entity included in unitary returns in prior years?
3. Was the disposition structured to take advantage of any tax attributes or to otherwise reduce the liability on the gain?

4. Will there be any tax filing positions taken on the selling entity’s federal or state tax returns as a result of the disposition?

5. Will all of the senior executives and employees who are familiar with the entity/assets be leaving the company as part of the disposition?

6. Are employees who are leaving the company “going away happy?”
   a. Critical witnesses for a case included an employee who was “downsized” and was not prepped by the taxpayer’s attorneys in connection with the subsequent tax case resulting in compelling testimony that was quoted by the court as a basis for its opinion.

7. Where will the corporate and tax documents go after the disposition is completed?

8. Are there provisions in the disposition documents addressing responsibility for tax in pre-disposition tax years, and mandating cooperation in future audits?

B. Acquisitions of assets/entities.

1. Is it preferable to establish that an acquired company is, or is not, instantly part of the company’s unitary business?
   a. Will the company’s records support such a position?
   b. Consider repercussions of a position being upheld in one state and then hurting a contrary position in another state.

2. Are there any tax issues concerning where in the company’s organization the acquired entity will be placed?

3. How will the motives for the acquisition be documented?

4. What are the effects of the acquisition on the acquired entity’s tax attributes?

5. Was any due diligence done on the acquired entity’s tax issues?

6. Who is responsible for the acquired entity’s tax issues prior to the acquisition, including ongoing audits, and is there a duty to cooperate in connection with ensuing controversy as to existing issues at the time of the acquisition?

7. Will the acquired entity’s tax department be eliminated or downsized?
8. Who is responsible for maintaining and storing the acquired entity's historic tax documents? Will the historic tax documents be transferred as part of the acquisition?

C. Internal restructurings.
   1. Does the restructuring have any tax benefits?
   2. What are the effects of the restructuring on existing tax attributes?
   3. Are the corporate names given to new entities appropriate?
   4. How has the business purpose for the restructuring been documented?
   5. Has the tax department reviewed board minutes, press releases, and other public documents?
   6. After the new structure is in place, which documents regarding the restructuring should be retained?

D. Positions Contrary to the Tax Authority's Known Position
   1. Presume that the tax authority will discover the position and that there will be a controversy beyond the administrative level.
   2. Is there sufficient support for the position to justify the ensuing controversy?
   3. Have you reached out to other taxpayers in the community to determine support at a more general level?
   4. Has there been adequate consideration of penalties?
   5. Have you considered the effect on reputation with the tax authorities, including more intense scrutiny in future audits?
   6. Will the tax benefit outweigh the costs considering legal resources required to support at judicial review?

Audit: The Opening Pitch
“In theory there is no difference between theory and practice. In practice there is.”—Yogi Berra

I. Make a Game Plan Before Meeting an Auditor
   A. If the company has been audited by the auditing state in the past, review the records of the previous audits.
1. Determine whether the audit examined ongoing tax issues that may reemerge in the current audit.
   a. If the previous outcome was positive, consider how the satisfactory outcome was reached and whether the same strategy may be used in the current audit. Also determine whether any new facts or new law may either strengthen or weaken the company’s position.
   b. If the previous outcome was not satisfactory, consider whether the company has new facts or whether there are new legal arguments that may bolster the company’s position this time around.

2. If a potential ongoing issue was missed in the previous audit, be prepared for the issue to be addressed in the current audit.

3. Be aware that the tax authority is not required to apply the same views from one audit period to another period.

B. Be familiar with possible audit issues, and be prepared to address those issues, if necessary.
   1. Review recent case law and legislation and consider “hot issues.”
   2. Stay engaged with and contribute to general taxpayer and industry groups, e.g., COST, IPT, and API.
      a. If not already connected with similar taxpayers where you discuss audit issues for your industry, consider starting up such a group.
   3. If a state has recently offered a voluntary compliance initiative with respect to a particular tax issue, taxpayers with that issue that have not participated may be targeted.

C. Re-examine the company’s document preservation policies.
   1. Once an issue has been identified on audit, the company may be obligated to preserve company records.
      a. Communicate preservation requirements to individuals and departments retaining pertinent documents and/or charged with document preservation (e.g., general counsel).
   2. Determine how the company plans to provide documents to the auditor.
      a. Will the company provide copies of documents or merely allow access to original documents on site at the company’s offices?
         (i) Generally never allow originals to be taken out of the company’s offices.
b. Be sure to keep complete records of exactly what documents were produced.

II. Avoid Audit Curve Balls

A. Play fair! Work toward establishing a good working relationship with the auditor.
   1. Respond to an auditor’s requests in a timely fashion, and communicate with auditor in advance when the company needs additional time.
   2. Provide responses that answer the auditor’s question.
      a. However, do not feel obligated to try and guess what an auditor is asking for when a request is unclear.
      b. Be honest and forthright without doing the auditor’s homework.
   3. If the need arises to go over the auditor’s head on an issue, inform the auditor beforehand.
   4. Consider identifying and conceding any obvious errors in the company’s tax returns prior to receiving questions from the auditor.
      a. Consider corporate policies requiring such disclosure.
      b. Consider nature of the audit team
   5. Provide an adequate location for the audit team – just not too adequate.
      a. Do not become the new “home office”.
      b. Ensure location is close enough to company personnel with whom there will be necessary interaction but not too close.
      c. Consider access to technology.

B. Make the auditor play fair!
   1. Know the rules of the auditor by reviewing the audit manual, along with any policy guidelines issued for audit.
   2. Require the auditor to put all document requests in writing. Keep a record of all requests received.
   3. Reach an agreement with the auditor as to when company documents will be provided as copies, and when company documents will have to be examined by the auditor at company offices.
   4. Require the auditor to provide notice of any formal or informal contact with third parties like former employees or other companies involved in previous transactions.
5. Establish a general timeline for the audit, with an anticipated completion date.
   a. Be aware of corporate “open year” policy.
   b. Advise of corporate policy regarding statute of limitations waivers and expectations.
   c. Do not let timelines slip.

6. Have the auditor identify and provide contact information for her supervisors—if problems arise in the audit, whether it be that the auditor is making unreasonable requests or taking a position that is contrary to developed law, it may be advantageous to advise the auditor that the company would like to address the situation with her supervisor.

C. Think critically about each information document request (“IDR”) response.

1. If an IDR requests documents that are not relevant to the audit, go beyond the scope of the audit, or are relevant to years outside of the audit cycle, discuss the company’s issues with the auditor and propose providing a more limited response.

2. If additional documents support the company’s position and help to “tell the story” but were not within the scope of the IDR, consider providing such documents.

3. If an IDR requests documents that the company does not create or maintain, like charts or computations, the company may not be obligated to prepare such documents.
   a. Nevertheless, consider whether preparing such documents may support the company’s position or make the audit move more smoothly.

4. Special issues:
   a. Should the company contest requests for consolidated federal tax returns in separate return states?
   b. Should the company contest requests for “50-state spreadsheets”?
   c. Should the company contest requests to provide other states’ tax returns?
   d. Should the company disclose the treatment of a transaction in other states?
(i) Recognize that in some states, the company may be required to make such a disclosure with its state tax return. For example, Massachusetts has such a requirement.

e. Should the company provide documents for domestic or foreign affiliates?

5. Issues with privilege:

a. Consider whether any documents are subject to the attorney-client privilege, work product doctrine, or accountant-client privilege.

(i) A few states have an accountant-client privilege, while most do not.

(a) Florida provides an accountant-client privilege. See Fla. Stat. § 90.5055.

(b) California generally requires accountants to keep client information confidential, but explicitly provides an exception to that rule for disclosures made in compliance with a subpoena or summons enforceable by order of a court. See Cal. Code. Regs. tit. 16, § 54.1.


(ii) In states without a privilege applicable to a necessary advisor, consider whether an arrangement has been made whereby the company’s attorney engaged the advisor to aid the attorney in the provision of legal services. See United States v. Kovel, 296 F.2d 918 (2nd Cir. 1961) (extending attorney-client privilege to client communications with an accountant retained by the law firm representing the client in order to help the attorney interpret the client’s financial data).

b. States also may have differing interpretations/applications of similar privilege rules.

c. Create procedures for handling and managing protected documentation, including marking documents, segregating documents, and restricting access to documents.
d. Consider the impact of providing privileged or protected documentation if the documents are helpful to the company’s position.

   (i) Be aware of whether producing the document will put privilege with respect to other documents in to risk.

e. Consider whether the company may be required to produce its tax accrual work papers. If the documents have been disclosed to an accounting firm, that may affect the ability to shield them from production. Compare United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982) (allowing IRS access to tax accrual work papers), with Wells Fargo & Co. v. United States, Misc. No. 10-57 (JRT/JJG) (D. Minn. 6/4/13) (allowing IRS access to uncertain tax positions but not to analysis of such).

D. Be prepared to handle auditor subpoenas.

   1. If a subpoena is issued, consider the reasons for its issuance.

      a. Is it being issued because the taxpayer provided no response to IDR?

      b. Is it being used as a “stick” to obtain an extension of the statute of limitations for issuing an assessment?

      c. Understanding the motivation for its issuance may help determine the best course of action.

   2. Consider whether the auditor has established a sufficient basis under the state’s statute and case law.

   3. Determine whether the subpoena was timely issued.

   4. Consider whether the subpoena could be cancelled and converted into an IDR.

   5. If there is a risk that third-party subpoenas may be issued in an audit, consider discussing with the target(s) and request that they advise the company upon receipt of a subpoena.

E. Request a summary statement of the auditor’s position on important issues in the audit, along with the auditor’s file if the issues may not resolve themselves at the audit level.

   1. In some states, the auditor may be required to produce her audit file under a freedom of information law (“FOIL”) or freedom of information act (“FOIA”).
a. Consider requesting state documentation related to the issues the company may challenge in litigation through a FOIL or FOIA request.

b. Be prepared to challenge the state’s withholding of documents, its claims of privilege, or any redactions and omissions from produced audit files or other requested documentation.

F. Although some auditors may not be authorized to settle all issues, resolution or settlement to the extent possible at the earliest stages in the assessment process may prove fruitful.

1. Some auditors may offer to concede certain issues, or offer not to apply assessments to certain taxable years, if the company agrees to accept other assessments.

2. Carefully consider whether to concede issues on audit, or keep open for potential settlement negotiations during the appellate process.

III. If the Company Strikes Out with the Auditor, Consider Other Options

A. Learn if an “exit conference” is available and consider whether it should be requested.

1. An exit conference may provide an opportunity to clarify the state’s position on substantive disputed issues.

2. An exit conference may also provide another opportunity to settle computational issues.

B. Determine whether to appeal the audit determination. Consider:

1. The dollar value of the issue;

2. Whether the issue is limited to the audit period, or if it is recurring; and

3. Whether the post-audit proceedings are public, and whether the company is comfortable with having a public record on the proceeding.

4. Know the history of appeals at the administrative level as well as how the specific issues fall out in administrative appeals.

Appeals: The Later Innings
“It ain’t over till it’s over.”—Yogi Berra

I. Reevaluate the Company’s Game Plan

A. Make sure the company follows laws requiring preservation of evidence.
1. Certain obligations to preserve records attach as soon as litigation has begun. Corporate general counsel’s offices often have established “litigation hold” procedures – make sure they are followed in tax cases.

2. Unfortunate or inconvenient information cannot simply be withheld.

3. The difficulty in obtaining and the expense of finding documents may not be an excuse for not producing those documents.

4. The risks of a charge of “spoliation” are adverse inferences, sanctions and/or bad publicity.

5. Consider all electronic data including data in PSTs, wireless devices (personal and corporate), and the “cloud.”

B. Understand what information the company currently has—and does not have.

1. Witness testimony may not be sufficient to win an appeal. Cf. Matter of Knowledge Learning Corporation and Kindercare Learning Centers, Inc., DTA Nos. 823962, 823963 (N.Y.S. Div. of Tax App., June 27, 2013) (ruling that taxpayers could not “meet their burden of proof . . . by relying on the testimony of their witnesses . . .”; the “lack of documentation . . . weighed heavily against petitioners”); Matter of Celtic Quest, Inc., DTA Nos. 825281, 824935 (N.Y.S. Div. of Tax App., Apr. 3, 2014) (concluding that the testimony of a vessel charter business’s president, chief operating officer, sole shareholder, and ship captain for the business’s ships was “credible testimony” sufficient to maintain the business’s tax position).

2. Develop a trial plan, which includes compiling and reviewing relevant documents, computations, facts, and potential witnesses.

3. Obtain as much detail as possible about transactions or positions.

C. Identify potential witnesses as soon as possible.

1. Schedule informal discussions with potential witnesses.

2. Consider preserving potential testimony in affidavits or proactive depositions in appropriate situations.

3. Think about a potential witness’s relationship with the company—could the potential witness be disgruntled?

II. States Have Widely Varying Tax Appellate Systems—Understand the Differences Between Each System

A. Review the appellate system in the state at issue, and consider the alternative avenues available for challenging an assessment.

1. State tax appeals systems vary widely by state. As examples:
a. In New York State, taxpayers generally must file appeals to an independent administrative body, the New York Division of Tax Appeals (“DTA”), and DTA decisions are reviewed by the New York Tax Appeals Tribunal.

(i) Taxpayers—but not the Department of Taxation and Finance—may appeal adverse Tribunal decisions in court.

(ii) In certain limited circumstances, the administrative review process may be avoided entirely and review may be sought in court.

b. New Jersey’s system gives a taxpayer the choice of filing a protest with the New Jersey Division of Taxation’s Conference and Appeals Branch, or appealing directly to the independent New Jersey Tax Court.

c. Massachusetts’s system requires taxpayers to file abatement applications with the state’s Department of Revenue. Denied abatement applications may be appealed to an independent administrative body, the Massachusetts Appellate Tax Board. Either losing party may appeal to the Massachusetts Appeals Court.

d. Texas requires taxpayers to file with the State Office of Administrative Hearings (“SOAH”) and then to exhaust all administrative remedies before filing with the Texas district court system.

2. Consider the facts and legal issues involved in the company’s assessment when determining an appeals strategy.

a. If the assessment was based on a clear misunderstanding or misapplication of the state’s tax laws, an administrative appeal may resolve the issue, even if the appeal is not to an independent body.

b. However, if the assessment was based on a tax position that has been clearly and consistently taken by the state’s department of taxation, consider limiting resources invested in any required administrative appeals process, especially if the administrative agency in charge of the appeal is not independent of the state’s department of taxation (but preserve issues and establish an adequate factual record to the extent necessary). If possible, consider bypassing the administrative appeals process altogether.

c. Taxpayers may need to raise constitutional issues in appeals to a state’s administrative body, even if that body has limited or no jurisdiction to consider constitutional issues. For example, in *L.L. Bean v. Levin*, No. 2010-A-2853 (Ohio Bd. of Tax Apps., Mar. 6,
Ohio’s administrative tax court explained that while it is the “receiver of evidence for constitutional challenges” in tax appeals, it may not rule on constitutional questions.

B. Consider at which level the record is made. The taxpayer may be precluded from raising new issues or presenting new facts after the record is closed.

1. In New York, the factual record is established before the administrative law judge at the DTA; generally, no additional facts may be presented on subsequent appeals.

2. In Pennsylvania, the taxpayer may establish a new factual record on appeal to the state’s Commonwealth Court, but if the taxpayer failed to raise an issue in the administrative appeals process, it is precluded from presenting the issue to the Commonwealth Court.

3. In Texas the district courts hear cases “de novo” hence any effort in bringing evidence to the administrative process must be replicated at the district court level.

4. It is advisable that counsel be involved at any level where the factual record is made or if a decision must be made as to the issues to be preserved.

C. Consider whether the state has pre-requisites to litigation. Some states require that a taxpayer pay all or a portion of a disputed tax in order to initiate or continue an administrative or court appeal. States have many different forms of “pay to play” systems. For example:

1. In California, a taxpayer may appeal an administrative determination upholding a franchise tax assessment in court only by paying the assessed tax and following statutory procedures for recovery. See Cal. Const. Art. XIII, § 32; Cal. Rev. & Tax. Code § 19382. The payment must include accrued interest. See Cal. Rev. & Tax Code § 19101(c)(1).

2. In Idaho, a taxpayer must pay 20% of assessed tax in order to file either an administrative appeal or a judicial appeal. See Idaho Code Ann. § 63-3049(b).

3. In Kansas, to appeal an administrative court decision a taxpayer generally must post a bond equal to 125% of the amount of taxes assessed. See Kan. Stat. Ann. § 74-2426.

4. In Texas, to appeal an administrative court decision a taxpayer generally must pay the tax, penalty and interest due or the suit is barred, though there remains a question whether the “open courts” provision of the Texas Constitution bars such requirement. See Tex. Const. art. I, § 13; Tex. Tax Code § 112.052.

III. Always Keep Settlement Options In Mind
A. Some states may offer formal mediation or settlement programs after audit or during an appeal.

1. New York offers taxpayers the option to request a conciliation conference with the Division’s Bureau of Conciliation and Mediation Services prior to initiating a formal appeal.

2. The California Franchise Tax Board has a separate settlement bureau through which all settlement discussions are mandated, with limited opportunity to involve audit for a final resolution of ongoing claims.

B. Even if no formal mediation or settlement program exists, settlement may still be possible.

1. Alabama, Louisiana and Texas all allow informal settlement negotiations with key players in the tax authority in which the taxpayer’s reputation and relationships with the tax authority play a key role.