Transparency and State Taxation
The Good, The Bad, The Gray

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Agenda

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- Background; Transparency in State Taxation
- Multistate Tax Commission – 51-State Spreadsheet
- Disclosure of Taxpayer Filing Positions
- Disclosure with Returns
- Financial Statement Disclosures
- Information Sharing Among State Tax Authorities
- Disclosure in Litigation
- Freedom of Information Act (FOIA) Requests
- State Guidance – Regulations, LRs, etc.

Background

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- Growing trend by State Tax Authorities to request information not previously required by a corporate income tax return
  - For example, increased disclosure of information in initial filings
  - Information requested:
    - May not affect tax liability as shown on the return
    - Increases compliance burden
- New developments in audit/financial statement disclosure; information sharing amongst the states
- Recent trend by taxpayers to make greater use of FOIA requests and requests for state guidance

Taxpayer Transparency: State Tax Reportable Transaction Statutes

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- Attempt to identify certain suspect or sham-like transactions
- Based on similar federal rules, proposed in 2000; finalized in 2003
- First version adopted by CA, 2003
- MTC model adopted in 2006; references transactions that lack economic substance
- Similar statutes enacted in ten states
- State statutes may notify states of federal or state reportable or listed transactions
- State statutes also generally provide for underreporting or other penalties

Taxpayer Transparency: MTC's 51-State Spreadsheet

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- Compilation of State Tax Return Data Model Statute
  - This model statute requires taxpayers to report certain data as it was filed in the other states in which the taxpayer does business "51 State Spreadsheet"
  - This "51-State Spreadsheet" includes:
    - business income, non-business income, apportionment factors, composition of the combined group
    - "In lieu" of exception – may file copies of all state tax returns in each state
  - Concept originally proposed by the 1984 Worldwide Unitary Taxation Working Group (which recommended "water's edge" combined reporting)

Taxpayer Transparency: MTC's 51-State Spreadsheet

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- **Goal:** to compile in one document basic pieces of tax information that already exists in taxpayer returns. Purposes include:
  1. Gain understanding of taxpayer filings; identify potentially inconsistent positions;
  2. Serve as a tool for narrowing audits so that they can be performed more quickly, or even be bypassed altogether;
  3. Foster an environment of greater transparency, and thus promote voluntary compliance; and
  4. Identify nowhere income and apportionment factors (*e.g.*, differences in the treatment of an item of income as business vs. non-business, differences in the reported members of the unitary group, or sales not sitused to any one state) to understand how the taxpayer reported in each state for the purpose of uniformity; thereby minimize duplicate or less than full apportionment of income amongst states

Taxpayer Transparency: MTC's 51-State Spreadsheet

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- Why is the 51-State Spreadsheet meeting taxpayer resistance?
  - Spreadsheet allows the state to compare taxpayer positions and filings in each state
  - The state's laws may be different (though the states could take that into account when reviewing the information…)
  - Taxpayers contend that this spreadsheet will not give states useful information, but will create confusion and result in additional compliance burden and “rabbit hole” audit questions

Taxpayer Transparency: Disclosure of Inconsistent Filing Positions

- Massachusetts; M.G.L. c. 62C, s. 35D
  - 2005 Massachusetts statute requires disclosure of an inconsistent filing position ("IFP")
  - A taxpayer must disclose any IFP as part of its corporate tax filing beginning December 8, 2005
  - If such IFP is not disclosed, the taxpayer will be subject to a penalty equal to the amount of tax attributable to the inconsistency
  - Penalty can be waived if the IFP was due to "reasonable cause"
  - Similar to MTC proposal that was abandoned in favor of the 51-state spreadsheet

Taxpayer Transparency: Disclosure of Inconsistent Filing Positions

- Massachusetts; M.G.L. c. 62C, s. 35D
  - A taxpayer is deemed to have taken an IFP when
    - (i) the taxpayer pays less tax in MA based upon an interpretation of MA law that differs from the position taken by the taxpayer in another state where the taxpayer files a return, ***and***
    - (ii) the governing law in that other state is the same in all material respects as the MA law

Taxpayer Transparency: Disclosure of Inconsistent Filing Positions

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Mass Regs. 830 CMR 62C.331.(5)(i), *Example 1*:

A foreign corporation doing business in MA sells the stock of a subsidiary. The corporation's commercial domicile is in another state. The corporation claims there was no unitary business relationship between it and the subsidiary and therefore does not apportion the gain from the sale in reporting income for MA corporate tax purposes. Rather, the corporation allocates the gain from the sale of the subsidiary to its state of commercial domicile, and it reports the gain in a consistent manner in its state of commercial domicile. The corporation ***is not*** subject to the penalty for an ***inconsistent filing position*****.**

Taxpayer Transparency: Disclosure of Inconsistent Filing Positions

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Mass Regs. 830 CMR 62C.331.(5)(i), *Example 2*:

The facts are the same as in Example 1 except that the corporation treats the gain from the sale of its subsidiary as apportionable income in its state of commercial domicile and does not report the inconsistency in reporting income for MA corporate tax purposes. The law in the corporation's state of commercial domicile is the same in all material respects. The corporation ***is*** subject to the penalty for an ***inconsistent filing position.***

Taxpayer Transparency: Disclosure of Inconsistent Filing Positions

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- *Oracle USA, Inc. v. Oregon Dep't of Rev.*, Or. Tax Ct. Case No. TC-MD 070762C (Feb. 11, 2010)
  - Taxpayer reported gain from the sale of stock as business income in its domiciliary state California, while classifying the same gain as non-business income under Oregon law
  - On audit, citing a regulation, the Oregon DOR reclassified the gain as business income asserting that the taxpayer was required to do so under UDITPA
  - The Oregon Tax Court held that a corporate taxpayer did not have a duty under UDITPA to uniformly report an item of income as "business" or "non-business" among MTC states notwithstanding uniform definition
  - Rather, the proper classification of income in each state must be determined according to that state's laws

Taxpayer Transparency: Legislation

- Connecticut Proposed House Bill 5337 (2009)
  - Business corporation tax returns and supporting documentation are public information under FOIA if:
    - Taxpayer reports more than $10 million in total sales for the tax year; or
    - Taxpayer receives more than $50,000 in Connecticut tax credits in a tax year
  - Status
    - Failed to obtain “favorable” recommendation from Jt. Comm. on Finance, Revenue and Bonding by April 17, 2009 deadline

Taxpayer Transparency: Legislation

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- Florida Proposed Senate Bill 1406; House Bill 675 (2010)
  - “Domestic Disclosure Spreadsheet”
    - Income reported to each state;
    - State tax liability;
    - Apportionment and allocation methods for each state; and
    - “Other information required by the department by rule in order to determine the proper amount of tax due to each state and to identify the water’s edge group”
  - Part of failed combined reporting bill
  - Also included in prior sessions’ (failed) combined reporting legislation, e.g., SB 2766/HB 1237 (2008) and SB 2270/HB 1247 (2009)

Taxpayer Transparency: Legislation

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- Massachusetts, G.L. c. 62C, s. 89(a) (2010), pertaining to credits
  - Law requires public disclosure of the results of the state's refundable or transferable tax credit programs, including the taxpayers who receive the credits and the amount of the credits conferred

Taxpayer Transparency: Legislation

- State "add back" laws
  - For a corporate taxpayer to obtain an "exception" and thereby deduct an intangible or interest expense incurred to a "related member" it must often supply a schedule or other information concerning:
    - The legitimacy of the underlying transaction
    - Tax liability of the related member with respect to the payment in one or more other states (i.e., for purposes of obtaining a "double tax" exception)
  - Mass Regs, 830 CMR 63.31.1: requirement that taxpayer prepare a contemporaneous "supporting statement" to be made available to the Commissioner upon her request

Taxpayer Transparency: Corporate Reporting Disclosure Requirements

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- Maryland (Md. S.B. 2, s. 6 (2007), as subsequently amended by SB 444, HB 664 (2008))
  - Maryland corporate taxpayers that are members of a “corporate group” are required to report a pro forma water’s edge return to Maryland as if Maryland was a unitary reporting state
  - Purpose of information reporting is to allow Maryland to “study” combined reporting
  - Separate state reporting still mandated under state law
  - Penalties may be imposed for failure to comply
  - Viewed by taxpayers as requiring the business community to provide state revenue estimates
  - The resulting study for the 2007 tax year indicated that Maryland revenue would increase in the range of $94 to $144 million

Taxpayer Transparency: Federal Increased Disclosure

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- The IRS has developed alternative methods for required disclosure of certain information
  - For example, Schedule M-3 requires detailed reconciliation between financial statement net income and federal taxable income
  - M-3 also requires certain specific expense items to be reconciled between GAAP & federal tax
- Recent IRS proposal that taxpayers must disclose “uncertain tax positions” (UTPs); IRS Announcement 2010-9

Taxpayer Transparency: Federal Increased Disclosure

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Version A, cycle 6

SCHEDULE UTP (Form 1120)

Department of the Treasury
Internal Revenue Service

Uncertain Tax Position Statement

► File with Form 1120, 1120-F, 1120-L, or 1120-PC.
► See instructions.

OMB No. 1545-0000

2010

Name of entity as shown on page 1 of tax return | EIN of entity

This Part I, Schedule UTP (Form 1120) is page ______ of ______ Part I pages.

Part I **Uncertain Tax Positions For the Current Tax Year.** See instructions for how to complete columns A through F. Enter, in Part III, a description for each Uncertain Tax Position (UTP).

Check this box if the corporation was unable to obtain information from related parties sufficient to determine whether a tax position is a UTP (see instructions) ► ☐

A. UTP No.	B. Primary IRC sections (e.g., "61", "108", etc.)			C. Timing Codes (check if Permanent, Temporary, or both)		D. Pass-Through Entity EIN	E. Check if Administrative Practice	F. Maximum Tax Adjustment (size of issue)
				P	T	-	☐	
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For Paperwork Reduction Act Notice, see the instructions. Cat. No. 54658Q Schedule UTP (Form 1120) 2010

Taxpayer Transparency: California

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- California
  - Schedule M-3
    - State specific schedule M-3 requires detailed reconciliation and state specific adjustments
  - Large Corporate Underpayment Penalty
    - Taxpayers required to file amended returns with detailed disclosure of each uncertain tax positions by May 31, 2009
    - Failure to file may result in imposition of 20% penalty

Taxpayer Transparency: Legislation

- Colorado’s recent sales/use tax reporting statute; CRS s. 39-21-112(3.5)
  - Vendors are required to provide additional information to the state concerning in-state purchases, including information regarding the purchasers, when they are not collecting sales/use tax on such purchases
  - In addition, said vendors must provide additional information to such consumers concerning (1) the fact that state tax applies to their purchases and (2) the annual amount of such purchases
- Oklahoma notice requirement
  - HB 2359 creates a Colorado-style notice requirement informing purchasers that they are liable for use tax, but the Oklahoma legislature did not go so far as to create the end-of-year reporting requirements regarding customer purchases to the state

Taxpayer Transparency: Legislation

- Colorado's recent sales/use tax reporting statute
  - Information required to be provided to the state resembles information sometimes requested by subpoena at the audit level
    - For example, in recent North Carolina contested subpoena to Amazon seeking records concerning in-state purchases/purchases
    - In latter action, Amazon claims, *inter alia,* North Carolina should be proscribed from obtaining information that is confidential under the Video Privacy Protection Act
    - The ACLU has intervened in the Amazon case on behalf of seven Amazon customers to protect their interest in maintaining privacy regarding their purchase histories. Causes of action include the First and Fourteenth Amendments and the federal Video Privacy Protection Act

Taxpayer Transparency: Disclosure of Financial Statement Workpapers

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- IRS officials consider FIN 48 workpapers to be tax accrual workpapers
- Some state and local tax agencies have sought to obtain tax accrual workpapers
- Should a taxpayer be forced to disclose its “level of comfort” with a tax position and the surrounding analysis?

Taxpayer Transparency: Disclosure of Financial Statement Workpapers

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- Attorney-client privilege does not apply to tax accrual workpapers because of the use of outside accountants; *see, e.g., Commissioner of Revenue v. Comcast Corp.*, 453 Mass. 293 (2009)
- *U.S. v. Textron, Inc.*, 577 F.3rd 21(1st Cir. 2009), *cert. denied*, ---S.Ct.---, 2010 WL 2025148 (May 24, 2010): the “work product ” doctrine does not protect such workpapers so the IRS can request these documents because they are prepared for non-litigation regulatory purposes
  - Tax audit process is not considered to be the equivalent of litigation
  - En banc decision reverses prior decision by the First Circuit
  - Compare *Comcast* where the work product doctrine was held to protect tax planning memos prepared by an outside accounting firm

Taxpayer Transparency: State Information Sharing

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- Uniform Exchange of Information Agreement was executed in 1993
- Currently all states (except New Mexico and Nevada), New York City and DC are signatories to the Agreement
- Multistate Tax Commission is also a signatory
- In 2005, cooperation between the MTC and 16 states leads to an over $400 million recovery in a state tax bankruptcy matter

Taxpayer Transparency: State Information Sharing

- Statutes and Regulations
  - State statutes typically follow IRC § 6103, with possible exceptions (*e.g.*, tax incentives) and/or considerations for state constitutional provisions
  - Statutory similarities:
    - Exception to general taxpayer confidentiality rule;
    - Other state's representative must be "authorized;"
    - Reciprocity; and/or
    - "Tax purposes" only
  - Examples
    - New York: N.Y. Tax Law § 202(3);
    - North Carolina: N.C. Gen. Stat. § 105-259(b)(3);
    - Florida: Fla. Stat. §§ 213.053(7)(j), 213.0535; Fla. Admin. Code 12-22.007;
    - New Jersey: N.J. Rev. Stat. § 54:50-9(f)

Taxpayer Transparency: State Information Sharing

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- Statutes Often Define The Types Of Information A State May Share With Other States
- Examples
  - Typical information includes: tax returns/reports, registration applications, information obtained through audit, filing/non-filing status, and/or taxpayer’s name, address, FEIN
  - Other states permit more broad disclosure
    - For example, Washington defines “tax information” as including “the nature, source, or amount of the taxpayer's income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability deficiencies, over assessments, or tax payments, whether taken from the taxpayer's books and records or any other source.” R.C.W. § 82.32.330(1)(c)

Taxpayer Transparency: IRS & MTC Sharing

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- IRC Section 6103(d) authorizes the IRS to share tax information with state tax agencies for tax administration purposes; comparable state statutes allow the states to share their information with the IRS
- The IRS shares information with all 50 states in accordance with written agreements generally known as Fed/State agreements
- IRC Section 6103(n) authorizes the IRS to share tax information with any person to the extent necessary in connection with providing services for purposes of tax administration; the MTC, in consultation the IRS, developed an MOU that states could enter into with the MTC that would allow MTC to obtain information from, and share information with, the IRS
- The MTC Joint Audit Program states executed this MOU with the MTC; MTC is working with the IRS to fully implement the exchange of information

Taxpayer Transparency: NESTOA Agreement re Credit for Taxes Paid

- North Eastern State Tax Officials Association Agreement to apply uniform criteria for determining individual taxpayer's domicile
- Established a system of interstate sharing of data and compliance techniques in the area of domicile and statutory residencies
- Uniform rules in the sourcing of income and the calculation of credits for taxes paid to other states.

Taxpayer Transparency: Disclosure In Litigation

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- The Oregon Dep't of Revenue requested business records in order to determine if Harley-Davidson was protected from taxation under P.L. 86-272. *Harley-Davidson, Inc. v. Dep't of Revenue*, No. TC MD0408097A (Or. Tax 2006)
  - Harley claimed it did not want information about trade secrets, customer lists and employees to become public
  - The Department indicated it would, if asked, share the requested information with other states and the MTC
- The Tax Court noted under OR law the information could only be shared with another state "for tax purposes," and only if the state "has a provision of law which meets the requirements of any applicable provision of the IRC as to confidentiality"
- The Tax Court denied Harley's motion for protection stating it had not demonstrated that the request would cause "annoyance, embarrassment or oppression" within the meaning of OR law

Taxpayer Transparency: Disclosure In Litigation

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- North Carolina
  - Wal-Mart was involved in corporate income tax litigation with North Carolina over the treatment of payments to a REIT
  - Wal-Mart filed motion for a protective order to seal all future filings after embarrassing materials were disclosed (i.e., E&Y state tax planning promotional materials)
  - Court did not grant the motion to seal the record

State Transparency: FOIA Requests

- Common Law right
- Broad Scope
- Federal Freedom of Information Act
- Scope
  - Applies to executive branch public bodies
    - Local governments
  - Does not apply to legislative bodies and courts
- Purposes
  - Request documents outside the context of litigation or an audit
  - Review state contracts with 3rd party auditors and collectors

State Transparency: FOIA Requests

- States vary drastically in scope of open records law
  - 2002 study by the Better Government Association ranked states
    - Best states (B grade): Nebraska, New Jersey
    - Worst states (F grade): Tennessee, Montana, Arizona, Wyoming, Alaska, Pennsylvania, Alabama, South Dakota
- Who can make request
  - Nonresidents?
  - Corporations?
- Documents Covered
  - “public writing”
  - computerized information
  - drafts
- Timing of public body response
- Notification of reasons for denial

State Transparency: State Guidance

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- Taxpayers can have difficulty getting State Tax Authorities to provide guidance on specific legal issues (particularly fact-intensive issues) thru letter rulings
  - Some states will not issue rulings on nexus issues (*e.g.*, Georgia, California)
  - Some states will not rule on issues of fact (e.g., Colorado, Georgia)
  - Some states do not issue any rulings (e.g., District of Columbia)
- States vary in whether they will allow taxpayers to request anonymous rulings and whether such rulings are binding
  - Certain states will only issue rulings to taxpayers that disclose their identity (*e.g.*, Georgia)
  - Generally, anonymous rulings are not binding on the state
- States may charge taxpayers a fee to response to a letter ruling (e.g. Colorado)
- Some taxpayers use Freedom of Information Act Requests to attempt to identify State Tax Authorities' positions on technical tax issues
- Are some taxpayers seeking guidance or a "green light"?

State Transparency: Discovery of State Tax Authority's Information

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- States may not always provide taxpayers with guidance on how they administer and apply state laws
- But some issues don't lend themselves to allowing the state to provide such guidance…
- In current litigation in North Carolina, *Delhaize America, Inc. vs. Hinton*, Secretary of Revenue of the State of North Carolina, Plaintiff asserted that North Carolina had secret laws regarding its rules, regulations and policies on when a forced combined return would be required to be filed by the state
- Plaintiff uncovered emails and other communication within the Department of Revenue that indicated that the Department did not want to disclose its policies on forced combination to taxpayers or auditors for fear that taxpayers would plan around such rules