Review

Multistate Tax Commission

Table of Contents

From the Executive Director.. 3

An MTC Mediation Success Story
By Mark Buchi, Holme, Roberts & Owen LLP, Salt Lake City, UT; Bruce Ely, Bradley Arant, Rose & White LLP, Birmingham, AL; Stewart Weintraub, Schnader Harrison Segal & Lewis LLP, Philadelphia, PA; and Steve Young, Holme, Roberts & Owen LLP, Salt Lake City.. 4
The authors, four attorneys, describe the predicament faced by their client, a natural gas producing firm, when two states imposed their business income tax on this firm. The case described in this article is commonly known as the "Chambers" case, after one of the three individual taxpayers. Fortunately, the story ended positively in 2007 when two states threw equitable rescue ropes to the taxpayers through mediation before the Multistate Tax Commission (MTC). Alabama, Utah and the MTC are to be congratulated for stepping up and doing the right thing, when legally they could have extended the taxpayers' nightmare for many more years. The fascinating case, replete with tax fictions and constitutional issues, is a great case study on several fronts. This article highlights the availability and benefit of MTC mediation in a multistate tax dispute.

Could FIN 48 Have Contributed to an Increase Tax Compliance Among Non-Filers?
By Elliott Dubin, Multistate Tax Commission and Ann Boyd Watts, University of Tennessee.. 7
This paper investigates the impact that FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* FIN 48 had on tax compliance. The authors examine the increase in the number of applicants for income tax in the Voluntary Disclosure Program run by the MTC's National Nexus Program to test whether FIN 48, did, in fact, result in greater tax compliance. From 2003 to 2006, the number of voluntary disclosure agreements for income taxes doubled. For the first sales and use tax agreements in 2006. While the level of voluntary disclosure agreements increased for income taxes, it remains unclear whether this increase is from actual noncompliance of businesses or noncompliance resulting from the uncertainty in the definition of nexus for income tax purposes.

Professional Development of State Personnel 15

Calendar of Events... 16

Working Together Since 1967 to Preserve Federalism and Tax Fairness

Multitstate Tax Commission Review

A Journal on State Taxation of Multijurisdictional Commerce

Published by: Multistate Tax Commission
Chair: Stephen M. Cordi, Deputy Chief Financial Officer for Tax and Revenue, District of Columbia
Executive Director: Joe Huddleston
Managing Editor: Elliott Dubin
Production Editor: Teresa Nelson

Subscriptions: The Review will be issued as a complimentary publication.

Contributions: Submissions of articles, article ideas, suggestions, and criticisms are welcome. Please send them to the managing editor at the address listed on the back. We also welcome information concerning changes in employment status of persons active in state taxation in both the public and private sectors.

The opinions expressed in the Review are those of the authors and do not necessarily represent the official position of the Multistate Tax Commission or any of its Member States.

MTC Officers FY 2008-09

Chair
Stephen M. Cordi
Deputy Chief Financial Officer
for Tax and Revenue
District of Columbia

Vice Chair
Tim Russell
Commissioner
Alabama Department of Revenue

Treasurer
(vacant)

Executive Committee Members
Susan Combs
Comptroller
Texas Comptroller of Public Accounts
Ward Einess
Commissioner
Minnesota Department of Revenue
Roxy Huber
Executive Director
Colorado Department of Revenue
Selvi Stanislaus
Executive Officer
California Franchise Tax Board

Member States

Compact Members
Alabama
Alaska
Arkansas
California
Colorado
District of Columbia
Hawaii
Idaho
Kansas
Michigan
Minnesota
Missouri
Montana
New Mexico
North Dakota
Oregon
South Dakota
Texas
Utah
Washington

Sovereignty Members
Georgia
Kentucky
Louisiana
Maryland
New Jersey
West Virginia

Project & Associate Members
Arizona
Connecticut
Florida
Illinois
Indiana
Iowa
Maine
Massachusetts
Mississippi
Nebraska
New Hampshire
New York
North Carolina
Ohio
Oklahoma
Pennsylvania
Rhode Island
South Carolina
Tennessee
Vermont
Wisconsin

FROM THE EXECUTIVE DIRECTOR

This issue of the *Review* showcases two important Commission programs. The first is the Alternative Dispute Resolution (ADR) program: "An MTC Mediation Success Story," which previously appeared in *NewsQuarterly* and is reproduced here with the permission of the American Bar Association. This article, by four attorneys, Mark Buchi, Bruce Ely, Stewart Weintraub, and Steve Young, details the successful experiences their clients had when they availed themselves of MTC's ADR program. In short, this program significantly shortened the expected time needed to resolve a dispute among a natural gas producing partnership and two states which wanted to impose their tax on the partnership's income. The attorneys laud the MTC, the mediator, and the two states in question for their professionalism and willingness to resolve this dispute. The article highlights the benefits of using the MTC ADR in such disputes.

The second is the Voluntary Disclosure Program (VDP) administered through the Commission's National Nexus Program. Elliott Dubin, MTC's Director of Policy Research, and Ann Boyd Watts, a Policy Research intern from August through November 2008, looked at VDP data to see whether the Financial Accounting Standards Board interpretation: Accounting for Uncertainty in Income Taxes affected the number of voluntary disclosures. They note, in "Could FIN 48 Have Contributed to an Increase in Compliance Among Non-Filers?," that the number of income tax voluntary disclosures did rise in anticipation of the release of FIN 48.

We're already planning the next issue of the *Review*, and I'd like to whet your appetite for the two articles that will be featured. One article will be on the effect of the transition from Generally Accepted Accounting Principles (GAAP) to the International Financial Reporting Standards (IFRS) on state corporate income taxes. The other article will look at the affect of changes in the apportionment formulas on state corporate income tax bases. The issue will also recap the activities at the annual meeting in Kansas City.

We welcome your suggestions for topics and submissions for future issues of the *Review.*

Joe Huddleston
Executive Director
Multistate Tax Commission

An MTC Mediation Success Story

By Mark Buchi, Holme, Roberts & Owen LLP, Salt Lake City, UT; Bruce Ely, Bradley Arant, Rose & White LLP, Birmingham, AL; Stewart Weintraub, Schnader Harrison Segal & Lewis LLP, Philadelphia, PA; and Steve Young, Holme, Roberts & Owen LLP, Salt Lake City

This article appeared in ***NewsQuarterly***, Volume 27, No. 4, Summer 2008. It is reproduced here with the written consent of the American Bar Association.

Since the implementation of the Uniform Division of Income for Tax Purposes Act (UDITPA) in the 1950s, courts, commentators and legislators have hypothesized about the pitfalls of a non-uniformly applied multistate corporate income tax system. In 2000, three individuals got caught by the perfect tax storm, and fell squarely into the pit. This is their story.

The case described in this article is commonly known as the "Chambers" case, after one of the three individual taxpayers. Fortunately, the story ended positively in 2007 when two states threw equitable rescue ropes to the taxpayers through mediation before the Multistate Tax Commission (MTC). Alabama, Utah and the MTC are to be congratulated for stepping up and doing the right thing, when legally they could have extended the taxpayers' nightmare for many more years. The fascinating case, replete with tax fictions and constitutional issues, is a great case study on several fronts. This article highlights the availability and benefit of MTC mediation in a multistate tax dispute.

Factual Background

In 1987, two Alabama engineers and a Pennsylvania attorney formed River Gas Corporation, an Alabama S corporation, to own and operate coal bed methane wells. In 1991, River Gas joined two major oil and gas companies in forming a joint venture to operate a gas-producing property in Utah. The joint venture was treated as a partnership for federal income tax purposes.

In 2000, the taxpayers sold all of the stock in River Gas to a major oil and gas company. Pursuant to section 338(h) (10), the sale was treated as a sale of the underlying assets by River Gas. Those assets included the interest in the Utah partnership (96%), an interest in an Alabama joint venture interest (3%), and goodwill (1%)—all intangible property. The sale produced a taxable gain of $273 million.

Based upon the decision in *Ex parte Uniroyal Tire Co*., 779 So. 2d 227 (ala. 2000), the River Gas shareholders reported the gain for Alabama income tax purposes as a gain from intangible property that produced non-business income allocable to Alabama (the domiciliary state of River Gas). They paid the applicable Alabama tax.

In 2002, Utah audited the shareholders and treated the gain as business income apportionable 62% (the apportionment percentage based on sales, employees, and property) to Utah. The resulting assessment created a classic case of double taxation.

To protect the clients' interest during the pendency of an appeal from the Utah assessment through the Utah courts, the taxpayers' attorneys filed refund claims in Alabama. When their claims were deemed denied due to the passage of time, appeals were taken to the Circuit Court in Montgomery, Alabama.

Legal and Procedural Issues

The case presented several legal issues:

(1) Whether the gain is business or non-business income;
(2) If the gain is non-business income, whether it is allocable 96% (the percentage of real property in Utah for allocation purposes) to Utah;

(3) Whether the taxpayers could seek a credit in Alabama for any taxes paid to Utah; and
(4) Whether the U.S. Constitution prohibits 162% taxation by Utah and Alabama.

The case also presented several interesting procedural issues:

(1) Whether the matter could be pursued in federal court;
(2) Whether it could be pursued before the U.S. Supreme Court;
(3) Whether the taxpayers could structure the timing of the respective appeals through the Alabama and Utah courts so both cases could be decided within the narrow window allowing for simultaneous petitions for certiorari being filed with the U.S. Supreme Court;
(4) Whether the parties could hold binding arbitration before the MTC; and
(5) Whether Alabama could be forcibly joined as a party in Utah state court or vice versa.

The taxpayers concluded that the legal issues were not clear cut, the answer to the first, third, and fourth procedural questions was "no," and the answer to the second and fifth procedural questions was unclear. Thus, applying equitable apportionment in mediation was the best means of resolving the dispute.

Getting to mediation

MTC Bylaw 14 provides a voluntary alternate dispute resolution/mediation program. Both Utah and Alabama are MTC "Compact Members"—states "that have enacted the Multistate Tax Compact into their state law."

When Utah first issued its assessments against the shareholders in late 2002, their counsel contacted the MTC regarding mediation. The MTC agreed to mediate the case, but Alabama refused to participate, and Utah refused to participate until the case had proceeded through the administrative process. The taxpayers' view was that this case was a perfect opportunity for the MTC to fulfill the purpose of the Compact to "avoid duplicative taxation," and to show taxpayers that the MTC was as much about promoting taxpayer fairness as about generating state revenues. Although the MTC eventually fulfilled this charge, it took several years to reach that point.

In 2007, Joe Huddleston, the MTC Executive Director, understood the opportunity the case presented for the MTC to fulfill its purpose of avoiding duplicative taxation. He began discussing the matter with the Alabama taxing authorities. Alabama soon agreed to attend a MTC mediation with the taxpayers and Utah.

Keys to the Successful Mediation

The mediation was held on October 24-25, 2007, at the offices of the Alabama Department of revenue, with Alan Friedman as the mediator. The specific result of the mediation is confidential, but the result, based on equitable apportionment and allocation, was fair to the taxpayers and both states. It epitomized how an MTC mediation process should operate. Several factors contributed to the successful outcome, including the following:

Confidentiality. The assurance of confidentiality allowed all parties to openly discuss all risks and issues relating to the law, equity, and facts.

Opening Session with Uninterrupted Statements. At the beginning of the mediation, all participants gathered in one room. All individuals present, not just the attorneys, were allowed uninterrupted time to speak their mind at that time. This process was very cathartic for all involved. After five years of litigation, there was significant frustration on several fronts. This opening session allowed each person to speak to the other parties, expressing frustrations, conveying arguments, and recommending solutions. In addition to being therapeutic, the opening session also allowed each party to get a sense for the strength of the opposing parties' cases.

Looking the Other Parties in the Eye. A significant benefit of the opening session was that it added a human element to a five-year litigation. The mediation session was the first time the taxpayers had met the

taxing authorities from Utah and Alabama face to face. On paper, people can appear bureaucratic, wealthy, stingy, cold, etc. In person, it is very difficult to look someone in the eye and say "no." Getting in the same room, with a day and a half to focus on the issues, was a substantial key to the successful settlement.

Separate Rooms. Following the opening session, the three parties separated into different rooms for the remainder of the day, while the mediator moved from room to room discussing settlement options with each party. This process had the effect of prompting open and honest discussion with the mediator, with no posturing in front of the other parties. The mediator also used an effective tactic of assuring the parties that he would not convey information shared with him without permission. This further promoted full disclosure by all parties.

Two Days. The mediator wisely insisted that all participants block out half of a second day for the mediation, to allow sufficient time for venting, analysis and debate.

Mediator Equity Questions. The successful mediation was driven in part by three questions the mediator asked prior to the mediation:

(1) if only one party gave up something, what is the most equitable outcome?
(2) if two parties gave up something, what is the most equitable outcome? and
(3) if all three parties gave up something, what is most equitable outcome?

These questions prompted each party to think in terms of fairness, and also allowed the mediator to get a sense for what each party saw as a fair outcome.

Settlement authority and a Papered Agreement. A key to the successful mediation was that each party came with full settlement authority. They signed a temporary version of the agreement at the mediation.

Effective Mediator. Alan Friedman is to be highly complimented for the manner in which he conducted the mediation. While he is the former general counsel of the MTC, he did not view the case with government lenses on. He gave equal credence to the positions of all parties, and even helped crystallize and articulate arguments for each party.

Good Faith Attendance. The mediator helped assure success by asking every party to commit to attending the mediation in good faith.

Conclusion

The Chambers case is instructive for multistate taxpayers and governmental entities in many respects:

(1) dealing with multiple state agencies and taxpayers;
(2) answering specific legal and procedural questions;
(3) knowing how and when to involve the MTC in a multistate tax dispute; and
(4) knowing how to conduct a successful multistate tax mediation. Taxpayers and governmental entities are well advised to heed this guidance when the multistate storm clouds begin to circle.

Help Keep Our Database Up-To-Date

If you would like to be notified of upcoming meetings, hearings, and teleconferences, please send an email to Teresa Nelson at tnelson@mtc.gov. Include your full name, mailing address, telephone, fax and email.

Could FIN 48 Have Contributed to an Increase Tax Compliance Among Non-Filers?

Elliott Dubin, Multistate Tax Commission
Ann Boyd Watts, University of Tennessee
July 16, 2009

ABSTRACT

This paper investigates the impact that FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, had on tax compliance as evidenced through the increase in the number of applicants for income tax in the National Nexus Program founded by the Multistate Tax Commission. From 2003 to 2006, the number of voluntary disclosure agreements for income taxes doubled. For the first time in the history of the National Nexus Program, income tax agreements exceeded those of sales and use tax agreements in 2006. While the level of voluntary disclosure agreements increased for income taxes, it remains unclear whether this increase is from actual noncompliance of businesses or noncompliance resulting from the uncertainty in the definition of nexus for income tax purposes.

Edubin@mtc.gov, Director of Policy Research, Multistate Tax Commission
Awatts2@utk.edu, Policy Research Intern, Multistate Tax Commission and
Ph.D. Student, University of Tennessee

I. INTRODUCTION

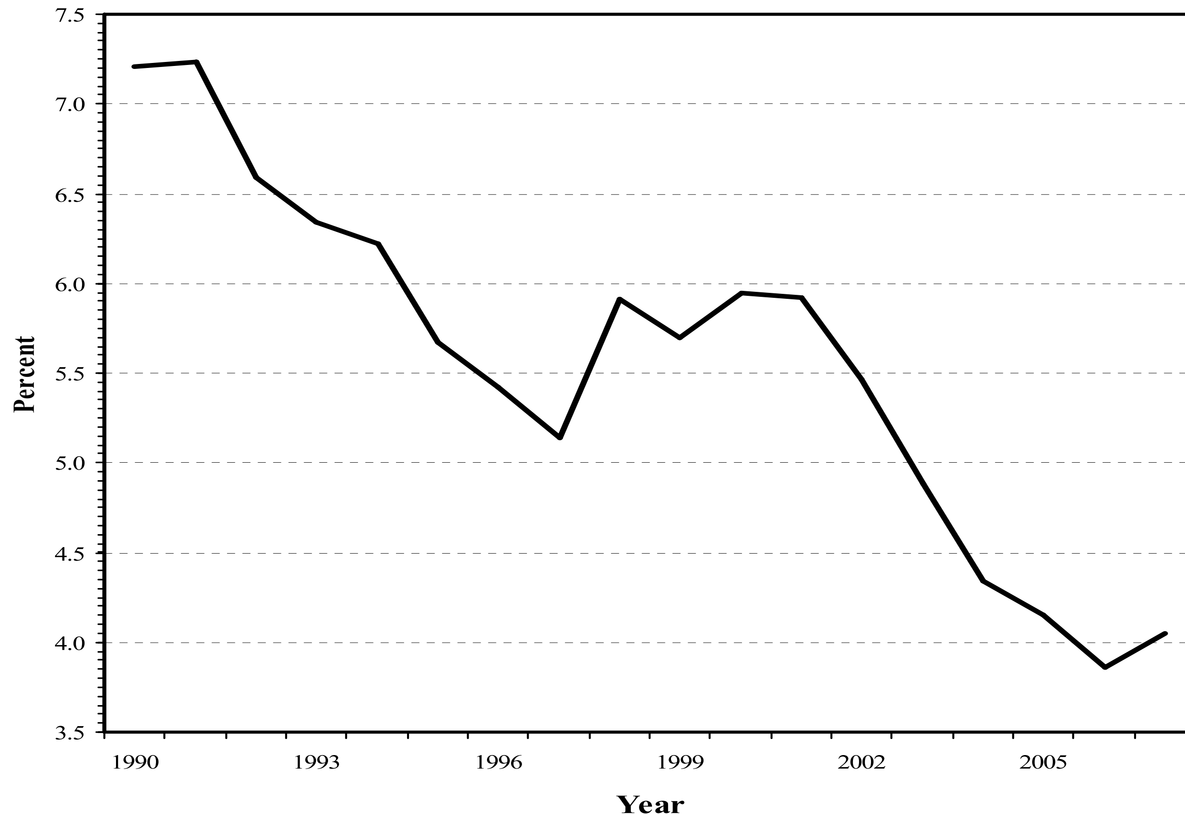
A. Trends in State Corporate Income Taxes

This paper examines the impact that FASB Interpretation No. 48 (FIN 48) has on tax compliance in the state income tax area. However, before our examination of FIN 48 and its impact on compliance for state business income taxes, we will examine some of trends in state corporate income tax revenues and state responses to a decline in business income taxation.

Until recently, most of the literature on state corporate income tax trends was devoted to the decline in this source of state tax revenue.[1] Between fiscal year 1979 and fiscal year 2007, the proportion of state taxes provided by corporate income taxes declined from 9.7 percent to 7.1 percent.[2] Today, most analysts of state corporate income taxes are noting its explosive growth. Since the trough in 2001, state corporate income tax collections, as presented in the National Income and Products Accounts, have grown at an astonishing annual average rate of 12.4 percent, largely attributable to the rapid growth in corporate profits before taxes. Over the past 18 years, state corporate income tax collections, have increased from $22.5 billion in 1990 to nearly $61 billion in 2007, or, approximately 6.0 percent per year on average[3].

Figure 1, however, paints a different picture of the state corporate tax environment showing state and local government taxes on corporate profits as a percentage of corporate profits. The ratio of state and local taxes on corporate profits to corporate profits, the effective tax rate (ETR), dramatically declined from 7.2 percent in 1990, to 4.1 percent in 2007 – a decline of 43.1 percent. This decline in the ETR occurred despite the aggregate legislated increases in state corporate income tax revenues totaling nearly $1.7 billion between fiscal years 1990 and 2007.[4] The decline in the effective profits tax rate since 1990 is difficult to explain because there are at least four non-mutually exclusive factors that caused the effective rate of profits tax to fall: 1) measurement errors; 2) changes in the Federal corporate tax base; 3) growth of more aggressive and sophisticated tax planning; and 4) actions of state policy makers.[5]

Figure 1
State and Local Government Taxes on Corporate Profits as Percent of Corporate Profits: 1990 to 2007



Source: Multistate Tax Commission from Bureau of Economic Analysis

B. State Responses to Declining Corporate Tax Revenues

States have responded to reduced revenues and corporate tax planning strategies by noncompliance in a number of ways. For example, states have: expanded the nexus threshold, taxed bases other than profits, required addbacks of intercompany expenses, required combined reporting, and decoupled from federal tax incentives.[6] States have also devised ways to make compliance easier for noncompliant individuals and business firms through amnesties and voluntary disclosure programs.

C. Compliance

Tax compliance is important due to equity between taxpayers, integrity of the tax systems, and effectiveness of tax collections. The tax gap represents the difference between the taxes that should be timely and accurately paid and those taxes that were actually paid for a given year. The IRS estimated the federal tax gap for 2001 for the corporate income tax at approximately $32 billion. This tax gap represented underreporting and underpayment noncompliance. However, there was no estimate given for the noncompliance associated with non-filing.[7] The Federation of Tax Administrators Compliance Workshop estimated the 2004 tax gap for underreported sales and use tax to be between $6 and $9 billion and uncollected tax on remote sales to be between $8 and $9 billion. The tax gap for domestic and international corporate income tax sheltering was estimated to between $10 and $17 billion.[8]

D. State Responses to Noncompliance

As stated previously, states have responded with amnesty programs and voluntary compliance programs in order to prevent the erosion of revenues through noncompliance. States tend to view these as inexpensive and politically popular methods to raise much needed short-term revenues. In addition to state amnesty programs for personal and corporate income taxes as well as sales and use taxes, the Multistate Tax Commission (MTC) has been instrumental in providing multistate businesses the opportunity to anonymously come forward and resolve nexus issues with multiple states through the National Nexus Program (NNP). While all of these outlets have attempted to resolve the tax compliance issues facing states, perhaps the passage of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, has had a more dramatic impact on tax compliance around the corporate income tax than any of the measures recently attempted by states.

The next section examines the history of the NNP and identifies some of the trends in the program looking at both the sales and use taxes and income taxes. We also highlight some of the descriptive statistics of the program. The third second section discusses the rules and requirements associated with FIN 48. The fourth section specifically looks at the impact of FIN 48 on the number of applicants entering into voluntary compliance to shed light on whether a financial statement pronouncement can impact tax compliance. This section also examines the impact of the uncertainty in the definition of nexus on FIN 48. Finally, the last section concludes the paper.

II HISTORY AND FACTS OF THE NATIONAL NEXUS PROGRAM

The MTC established the NNP in December 1990 for the following purposes: (1) foster increased state tax compliance by business, (2) establish national cooperation in the administration of state tax issues arising in the nexus area, (3) facilitate taxpayer compliance through education, and (4) promote fair, even-handed and consistent state tax enforcement in the nexus area. The NNP allows firms the opportunity to anonymously approach states to settle potential liabilities resulting from prior activities. The voluntary disclosure aspect of the program remains the focal point with the program continually assisting multistate firms in resolving potential liabilities associated with both income taxes and sales and use taxes. From the businesses' perspective, the benefit stems from having potential state tax disputes resolved in advance of any prior year assessments of taxes, interest, and penalties. By focusing on an average of approximately 11 states for both income and sales and use taxes for each business, taxpayers also save time and money. The MTC staff performs a significant amount of the work at no cost to the business.

To take advantage of the NNP, a business approaches the MTC staff anonymously requesting voluntary disclosure. Based on the company's brief business description, the extent of operations in the relevant states, and the facts giving rise to the need for disclosure, the MTC staff advises the company of the various settlement alternatives that are likely to be accepted by the states based on previous history. The MTC staff also needs to know whether the company has been contacted by any of the states. If the company has been contacted, selected for audit, or under investigation, then the company will not be able to enter a voluntary disclosure agreement with that state. In the past 18 years, the NNP has been involved with over 400 businesses and processed over 9,000 cases. A case is unique to the anonymous company for a certain state for a specific type of tax. The primary types of taxes involved in the settlement agreements are income taxes and sales and use taxes. Income taxes comprise approximately 37 percent of the cases; while, sales and use taxes comprise 62 percent.

When a company contacts the MTC staff to voluntarily disclose information, a case is opened and remains open until the agreement is either settled, rejected, or withdrawn. On

average, there are 270 days between the date a case is opened and the date the decision of the agreement becomes effective. The settlement becomes effective after the MTC staff prepares the settlement agreement, the company reviews the agreement, and the state accepts the finalized agreement with the schedule of potential liabilities. Of the cases with finalized decisions, 96 percent of the cases are accepted by the states. Of the remaining open cases, 41 percent of them represent withdrawals by the company with another 40 percent representing pending cases.

Upon its initial conception, the NNP consisted of 21 participating states. Over 18 years later, 41 states participate in the program. While the service provided by the MTC through the NNP is free to the companies, states pay a member fee each year to be involved in this program. On average, each state pays approximately $15,500 per year in member fees; however, each state receives on average an additional $480,000 per year in tax collections from companies participating in the NNP. This represents nearly a 3,000 percent return on investment for the average state. The average tax collections per case are approximately $73,000 with the average tax collections per year approximately $17,178,000.

Throughout the 18 years, the NNP has substantially increased the number of agreements from over 200 in 1991 to slightly less than 800 in 2007. **Figure 2** shows the trend of the number of agreements based on the date a company enters into an agreement. In addition to the total trend in the number of agreements, the figure also shows the trend in tax collections. Until 2000, the number of agreements remained rather constant. Beginning in 2000, the general trend increased with the peak around 2003 and 2004. This general increase in voluntary disclosure coincided with the rise in state tax amnesty programs. In 2002 and 2003, the number of state tax amnesty programs was at the greatest involvement since 1982. Also, one of the largest and most aggressive combined reporting states, Illinois, had a state amnesty program with an amnesty period from October to November of 2003.[9] This could be a contributing factor in the rise of the overall trend in the number of NNP agreements.

While the number of NNP agreements have tended to increase over time, the level of tax collections were generally declining until 2000 with a slow rise through 2007.[10] The general decline in tax collections accompanied by a rise in the number of agreements tends to indicate that the size of businesses, or at the very least the size of the settlement, has decreased. This seems to be consistent with Gupta and Mills' finding that larger businesses operating in multiple jurisdictions reduce their state tax burdens indicating that the compliance costs of differing state laws fall disproportionately on smaller firms.[11]

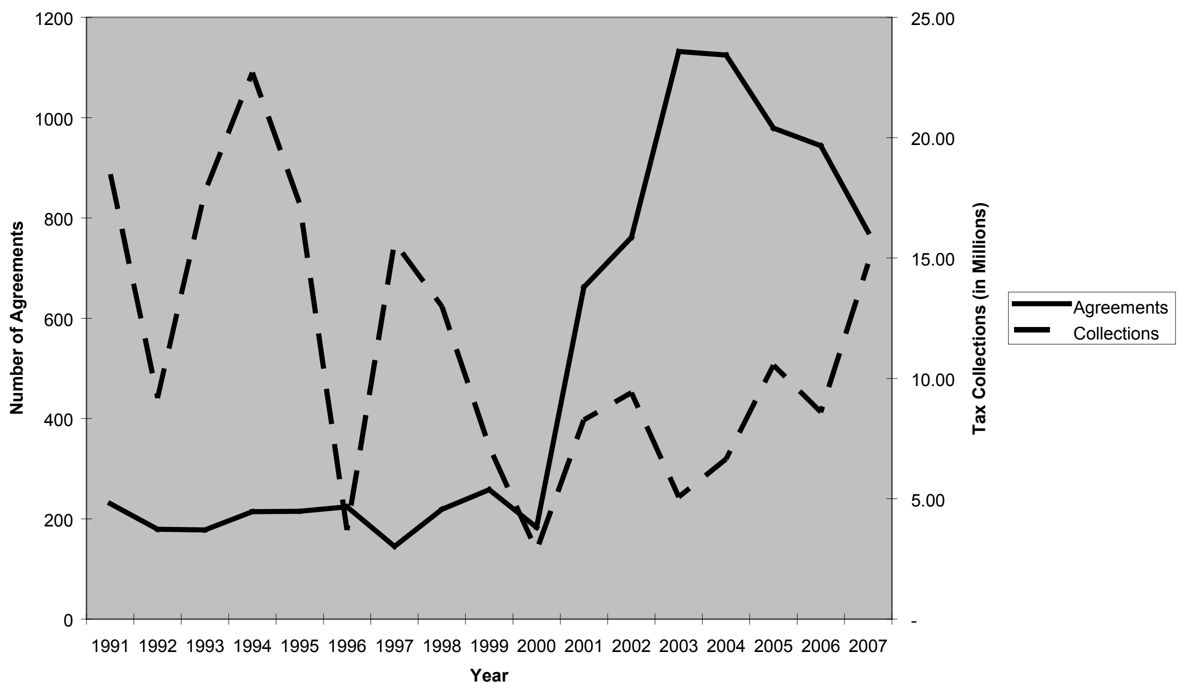
For sales and use taxes, **Figure 3** shows an upward trend with the ultimate peak in 2003 potentially being attributable to the Streamlined Sales Tax Project (SSTP). The trend in income taxes peaks in 2006, which coincides with the anticipation of the effective date of FIN 48 for publicly traded businesses. These upward trends, specifically the one associated with income taxes, will be discussed in the next two sections.

III. BASICS OF FASB INTERPRETATION NO. 48

In July 2006, FASB issued the final FIN 48 standard. For publically traded firms, the recording of the FIN 48 liability or unrecognized tax benefits and associated disclosure is effective for fiscal years beginning after December 15, 2006 (e.g., effective January 1, 2007 for calendar year-end firms). FIN 48 applies only to positions taken for taxes accounted for under FASB Statement No. 109, *Accounting for Income Taxes*. Therefore, FIN 48's focus is on tax positions associated with income taxes and not sales and use taxes. The purpose is to increase the comparability and transparency of financial reporting of income taxes as all firms must now use consistent criteria.

Figure 2: Historical Trend of National Nexus Program

Counts and Collections of Voluntary Disclosure Agreements
(Based on Offer Date)



Source: Multistate Tax Commission from National Nexus Program

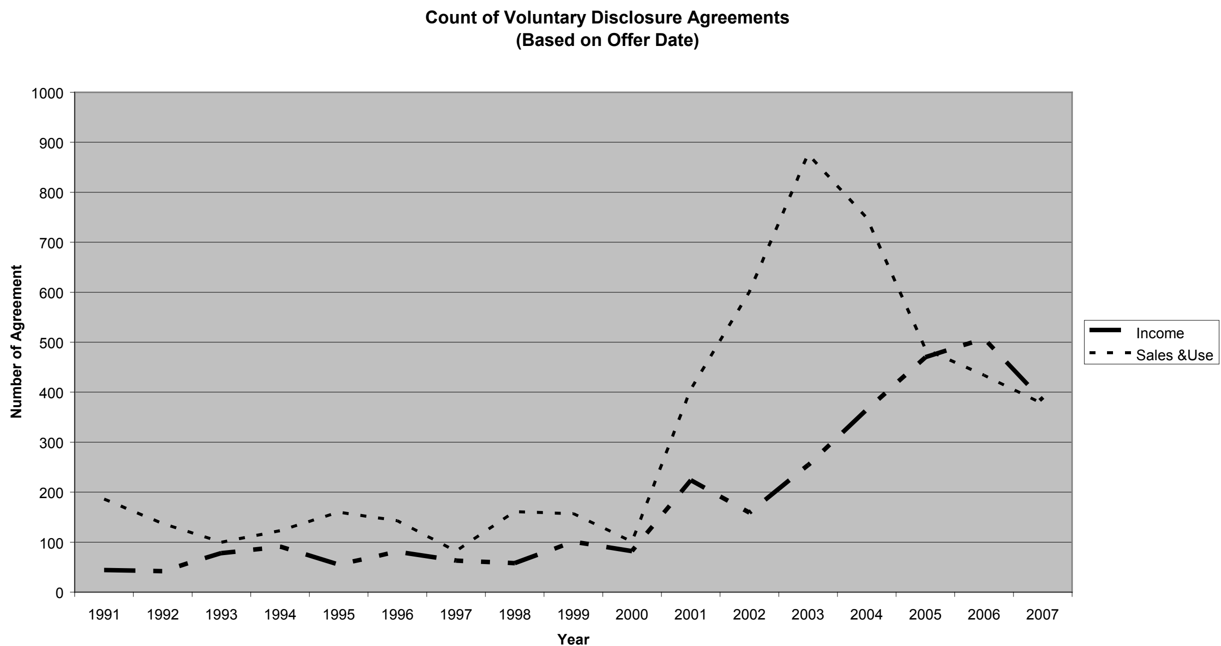
FIN 48 uses a two-stage approach of recognition and measurement. The first phase of recognition involves evaluating whether the tax position is more likely than not to prevail under audit. Here, the term "more likely than not" refers to a greater than 50 percent chance of occurrence. Prevailing under audit means the business makes it through appeals or litigation on the technical merits of the tax position, assuming that the examining jurisdiction has full knowledge of all facts and circumstances. The tax position must continue to be evaluated until the statute of limitations has closed with respect to a particular tax year.[12] If a tax position meets the more likely than not threshold, the company measures the tax position as the largest amount of the tax benefit that is greater than the 50 percent likelihood of prevailing under audit. This represents the amount of the tax benefit that is recognized in the financial statements. The measurement exercise results in the amount of the tax benefit that is not recognized being reflected as the FIN 48 liability. For tax positions that do not meet the recognition threshold of more likely than not, the full amount of the tax benefit is recorded as a FIN 48 liability. Companies must also accrue for interest and penalties that would be assessed under the current tax law if the tax position were not sustained under audit.

In addition to the two-stage approach, FASB also focuses on disclosure and presentation to provide additional transparency. FIN 48 requires companies to disclose the policy for classification of interest and penalties as well as the amount of interest and penalties included in the income statement and balance sheet. Another disclosure includes the tabular presentation reconciling the total amounts of the FIN 48 liability or unrecognized tax benefits at the beginning and end of the period. Consideration must also be given to whether the FIN 48 liability represents a current or long-term liability.

IV. IMPACT ON TAX COMPLIANCE

Based on anecdotal evidence and the

Figure 3: **Trend of Voluntary Disclosure Agreements between Income Taxes and Sales and Use Taxes**



Source: Multistate Tax Commission from National Nexus Program

experience of the MTC staff, many of the cases are opened due to nexus issues. Nexus is used to describe the level of in-state business activity that gives the state the right to impose a tax on the company. Under the Commerce Clause, a state may only tax a business if its activities result in "substantial nexus" within the state. In 1967 and again in 1992, the U.S. Supreme Court required an in-state physical presence test to satisfy the "substantial nexus" requirement.[13] Since these earlier Supreme Court rulings dealt with sales and use taxes, many states have asserted that the physical presence standard is not required for income taxes and that rather a significant economic presence is sufficient. While the U.S. Supreme Court has not ruled on physical presence for income taxes, several state courts have ruled on the issue. Recently, the New Jersey Supreme Court ruled that income tax nexus existed, although the trademark holding company had no physical presence.[14] Another similar decision resulted in West Virginia when the West Virginia Supreme Court of Appeals ruled that deriving income from customers in the state resulted in significant economic presence.[15] On the other hand, the Tennessee Court of Appeals, Texas Court of Appeals, Michigan Court of Appeals, and Missouri Supreme Court all support of physical presence standard. The ambiguity in nexus standards across states as well as the lack of information in how a state would rule on the nexus issue often results in uncertainty in the FIN 48 liability for a business.

According to FIN 48 (par. 4), the decision not to file a tax return, where a company might have nexus or a permanent establishment, is considered a "tax position." If the company cannot support the technical merits of the position at the more likely than not threshold, it must record a FIN 48 liability for the realized but unrecognizable tax benefit. The issue of nexus is further complicated by the statute of limitations not applying if a return has not been filed. Without the statute of limitations, there may be no limit to the number of open years associated with a non-filing position resulting from nexus issues. FIN 48 (par.

7) does allow the consideration of past administrative practices if the jurisdiction being evaluated has a widely understood practice of pursuing back-taxes for only a defined number of years. This accommodation allows companies to accrue taxes, interest, and penalties for a defined number of years similar to the statute of limitations.

In a comment letter to FASB dated January 8, 2007, the Council on State Taxation (COST), a nonprofit trade association comprised of multistate corporations engaged in interstate and international business, cites nexus as a reason for delaying implementation of FIN 48. Due to the controversy over the level of state activity required to establish nexus, many taxpayers will be required to reserve the full amount of tax benefit in jurisdictions where companies currently believe that they do not have nexus. In response to the problem, COST cites that "at least one accounting firm has publicly suggested that businesses should consider filing and paying taxes in jurisdictions where they may not have nexus because the alternative under FIN 48 is too large a dollar figure for the financial statement to bear." [16]

As a means to request clarification of the meaning of the Commerce Clause in the context of corporate income taxes, three trade organizations filed an amicus brief representing large taxpayers in state and local jurisdictions with the U.S. Supreme Court. Here, the organizations argue that the varying standards and lack of definition of economic nexus may cause taxpayers to interpret identical circumstances differently and record vastly different FIN 48 liabilities. Therefore, the lack of a consistent standard on nexus "frustrate[s] the goal of providing investors with a realistic picture of a corporation's financial position."[17] On June 18, 2007, the U.S. Supreme Court refused to grant certiorari in the two state court decisions that imposed New Jersey and West Virginia taxes on out-of-state businesses.[18]

To further highlight the need for Congressional action in the income tax nexus area, COST testified in the hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008" on June 24, 2008.. In this testimony, COST indicated that the uncertainty resulting from conflicting state interpretations of "substantial nexus" complicated the FIN 48 analysis. The testimony continued by indicating that the unsettled nexus issues may cause a business to be unable to meet the more likely than not threshold resulting in a FIN 48 liability. Also, this "phantom tax liability" never disappears due to no statute of limitations. [19]

Consistent with the above discussion, Figure 3 shows that the number of voluntary disclosure agreements based on the date the company contacted the MTC significantly increased for income taxes in 2005 and 2006. In fact, in 2006, the number of agreements entered into for income taxes exceeded those for sales and use taxes for the first time in the history of the NNP. The level of income tax voluntary disclosure agreements doubled from 2003 to 2006, a period before uncertain tax benefits were being discussed. During 2004, FASB board members and SEC representatives noted significant diversity in uncertain tax benefits and decided that uncertain tax benefits should be based on an amount that will be sustained under audit with the interpretation being effective for period ending after December 15, 2005. On July 14, 2005, FASB issued the exposure draft. On January 11, 2006, FASB announced a one-year delay in the effective date of the interpretation. FASB issued the final FIN 48 standard on July 13, 2006. During this time, there was extensive press coverage discussing the possibility of the Internal Revenue Service using this as an audit roadmap. Although there had been discussion of delay, FASB rejected the call for a one-year delay on January 17, 2007. According to Frischmann, Shevlin, and Wilson, the three dates around FIN 48 receiving the most extensive press coverage were July 14, 2005; July 13, 2006; and January 17, 2007.[20] The increased level of press coverage coupled with the uncertainty and concerns over nexus likely induced the rise in voluntary disclosures for income taxes that is now greater than sales and use taxes. Particularly, smaller to medium sized firms that were not already filing in almost all states but were publicly traded

company may have felt increased pressure from the discussion in the market as well as the nexus uncertainty to enter into voluntary disclosure agreements through the NNP. These firms were aware that without entering into a disclosure agreement they would have to indefinitely increase the FIN 48 liability for the non-filing tax position.

Alternatively, the overall rise in voluntary disclosure agreements during 2003 may also be associated with the increase in state amnesty programs. The substantial increase in sales and use tax disclosure agreements is likely to have resulted from the SSTP that was organized in March 2000 with the purpose of simplifying and modernizing sales and use tax collection and administration. On November 12, 2002, 30 states and the District of Columbia unanimously approved the Streamlined Sales and Use Tax Agreement in Chicago. After the vote, states moved forward in 2003 to turn this agreement into conforming legislation. The vote in 2002 was considered a significant milestone and likely resulted in the significant increase in sales and use tax voluntary disclosure agreements in 2003.[21]

V. CONCLUSION

While the overriding goal of FIN 48 was to increase transparency and promote more accurate financial reporting, it seems as though it has also increased state tax compliance as the number of businesses entering income tax voluntary disclosure agreements in the NNP doubled from 2003 to 2006. During this time period, the average annual increase in the number of agreements for income tax was 26.8 percent while sales and use tax agreements declined 20.1 percent annually. In 2006, the level of income tax agreements rose above those of sales and use taxes for the first time in the history of the NNP.

The reason for the rise in income tax voluntary disclosure agreements may be attributed to the uncertainty around states' positions on physical presence versus economic nexus standards highlighted in the recognition threshold of FIN 48. While reducing noncompliance would be a successful outcome of FIN 48, it is unclear whether the increase is due from actual noncompliance or noncompliance resulting from nexus uncertainty. Without a more clear and consistent nexus standard for income tax purposes, businesses will continue to struggle with the decision to record a FIN 48 liability or begin filing income tax returns in states where it is unclear whether the non-filing tax position is sustainable under audit. Therefore, if FIN 48 is going to increase the accuracy of financial reporting around uncertain tax positions, it seems imperative that the uncertainty around the nexus issue be resolved.

This paper does not examine the differences in public versus private businesses as FIN 48 was only effective for public businesses during this period. Also, we are not able to examine the differences in varying size of businesses. Further research hopes to examine these issues.

ENDNOTES

[1]See, for example, Elliott Dubin, "Recent Trends in State Corporate Income Taxes," ***Multistate Tax Commission Review,*** Volume 2000, No. 1, September 2000, pp. 7-15; Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," ***State Tax Notes***, March 4, 2002, pp. 767-774; William Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," ***National Tax Journal***, Vol LV., No. 3, September 2002, pp. 491-509; and Steven Maguire, Average Effective Corporate Tax Rates: 1959 to 2002, Updated September 5, 2003, ***CRS Report for Congress***, Order Code RL30469, pp. 6-7.
[2]U.S. Bureau of the Census, ***State Tax Collections,*** various fiscal years.
[3]http://www.bea.gov/national/nipaweb/TableView.asp?
[4]National Association of State Budget Officers, ***Fiscal Survey of the States***, fiscal years 1990 through 2007, annually.
[5]For a more thorough discussion of these factors, see: Elliott Dubin, "Trends in State Corporate Income Taxes Revisited," ***Multistate Tax Commission Review***, Vol. 20, No. 1 (Winter 2007), pp. 7-14; and, William F Fox,. and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," ***National Tax Journal***, Vol. 55, No. 3 (Sept. 2002), pp. 491-508.
[6]John J.Cronin, , Dan Bucks, Bruce Daigh, and Charles W. Drury, "State Tax Trends," ***Taxes***, Nov. 1, 2002. William F.Fox, LeAnn Luna, and Matthew N. Murray, "How

continued on page 16

MTC Training Supports the
Professional Development of State Personnel

Ken Beier, Director of Training

Student evaluations have been very positive for all recent MTC training courses: Nexus Schools (in Louisiana and Arkansas), the corporate income tax course (in West Virginia), and the statistical sampling course (in Kansas).

Additional information on MTC training, including complete course descriptions, scheduled courses, tuition, and registration can be found in the Training Programs page (under Events and Training) of our website at www.mtc.gov.

The objective of **Nexus Schools** is to provide participants with a detailed understanding of the constitutional principles and limitations for establishing nexus for corporate business taxes and sales/use taxes. Participants also learn current investigative approaches and audit techniques, including the types of information used to prove nexus. The primary audience for these classes is state revenue department auditors and attorneys who have had limited exposure to nexus issues, but are not experts in the area.

State and local sales & use tax auditors, computer audit specialists, supervisors and review section personnel can benefit from the sampling courses – **Statistical Sampling for Sales and Use Tax Audits** and **Basic Random Sampling** offered by the MTC. Participants gain an understanding of basic random sampling and more sophisticate sampling techniques and how these techniques are used in sales and use tax audits. The statistical sampling course utilizes MTC's sampling software.

The **Corporate Income Tax** course is designed to accomplish two complementary goals: 1) to educate state revenue representatives concerning the basic laws relating to the apportionment of corporate income taxes; and 2) to train state auditors in the application of those laws for purposes of auditing multistate businesses. Part One (2 days) is for any state revenue employee (lawyer, auditor, policy analyst or other) and can be taken on a stand-alone basis. Part Two (2 days) is primarily for state auditors or those who support state audit work. Part Two students also take Part One of the course.

The **Computer Assisted Audit Techniques** course provides participants with the confidence and skills to conduct an audit using electronic records. The primary audience for this course is state auditors who have a need to process electronic records in an audit environment.

The following training courses are scheduled at this time:

Nexus Schools
October 19-20, 2009 in Topeka, Kansas
December 7-8, 2009 in Lansdowne, Virginia
(Washington, DC Metro Area)

Statistical Sampling for Sales and Use Tax Audits
October 19-22, 2009 in Chicago, Illinois
March 22-25, 2010 in Dallas, Texas
June 7-10, 2010 in Atlanta, Georgia

Basic Random Sampling
September 14-18, 2009 in Mitchell, South Dakota

Did you know that...

- MTC provides a host state credit of up to **$3,000** against tuition for students from the host state?
- Private sector participants are invited to all currently scheduled sessions of the Statistical Sampling course?
- Private sector participants were included in **Part 1** of the recent Corporate Income Tax course in West Virginia?

To learn more, contact MTC Training Director, Ken Beier at 954-630-2540.

The Multistate Tax Commission is registered with the National Association of State Boards of Accountancy (NASBA), as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN, 37219-2417. Website: www.nasba.org.

Calendar of Events

Fall Program & Executive Committee Meeting
December 1-3, 2009
Orange Beach, Alabama

Winter Program Committee Meetings
March 2-5, 2010
Denver, Colorado

43rd Annual Conference & Committee Meetings
July 25-29, 2010
Hood River, Oregon

For further details of these and future meetings, please visit our website at *www.mtc.gov*.

continued from page 14

Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?" ***National Tax Journal***, Vol. 58, No. 1 (March 2005), pp. 139-159.
[7]**U.S. GAO**, Report 05-527T "Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies," April 14, 2005.
[8]Multiststate Tax Commission, "MTC State Tax Compliance Initiative," June 8, 2004, Bruce Johnson, chair.
[9]http://www.taxadmin.org/fta/rate/amnesty1.html
[10]In the time trend analysis of tax collections, two businesses were omitted as their level of collections represented outliers. These businesses had open dates during the mid-1990s.
[11]Sanjay Gupta, and Lillian F. Mills, "Corporate Multistate Tax Planning: Benefits of Multiple Jurisdictions," **The Journal of Accounting and Economics**, Vol. 33 No. 1 (Feb. 2002), pp. 117-139.
[12]For most states, the statute of limitations is typically three years.
[13]National Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 753 (1967) and Quill Corp. v. North Dakota, 504 U.S. 298 (1992)
[14]908 A.2d 176 (N.J. 2006)
[15]640 S.E.2d 226 (W.Va. 2006); cert, denied, U.S. Sup. Ct., 061228, June 18, 2007
[16]Smith, Diann L., "Comment Letter on Request for Delay in Implementing FIN 48," Council on State Taxation (**FASB File Reference 1215-U01**), Jan. 8, 2007.
[17]Council on State Taxation, National Association of Manufacturers, and National Marine Manufacturers Association, "Associations File Amicus Brief In U.S. Supreme Court in Support of Physical Presence Nexus Rule," ***State Tax Notes***, June 4, 2007, pp. 757-765.
[18]Gay, Patrice, "U.S. Supreme Court Will Not Hear Business Tax Nexus Cases," ***State Tax Notes***, June 25, 2007, p. 938.
[19]**Council on State Taxation**, Hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008" before the U.S. House of Representatives, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, June 24, 2008.
[20]Frischmann, Peter J., Terry Shevlin, and Ryan Wilson, "Economic Consequences of Increasing the Conformity in Accounting for Uncertain Tax Benefits," ***Journal of Accounting and Economics***, Vol. 46, No. 2/3 (December 2008), pp. 261-278..
[21]Hardt, Diane L., Douglas L. Lindholm, and Stephen P. B. Kranz, "A Lawmaker's Guide to the Streamlined Sales Tax Project," ***Journal of State Taxation***, Vol. 22, No. 2 (Fall 2004), pp. 1-29.
[22]Corporate profits of domestic industries before tax less earnings of Federal Reserve Banks.