Meeting Notes - Strategic Planning Compliance Project Work Team Teleconference

Thursday, January 24, 2013: 11:00 a.m. to 1:00 p.m. Eastern Time

I. Introductions – Attending: Cathy Felix, MTC; Steve Yang, MTC; Frank Hales, UT; Larry Shinder, MTC; JA Cline, LA; Les Koenig, MTC, guest; Jeff Serether, Ernst & Young, guest; Elizabeth Harchenko, facilitator.

II. Initial Public Comment Period – no public comment offered.

III. Project Work

A. Report on information from audit staff: Elizabeth had provided a set of questions for Steve, Cathy and Larry to discuss with MTC auditors about the possible characteristics and use of an early "no change" determination. Cathy and Steve had both surveyed their auditors by e-mail.

1. How often do you find that an audit or issue will likely be immaterial after an audit has been opened? For income tax audits, there will always be issues that will be immaterial, or for which no adjustment will be needed. Coming to that conclusion will take more time or investigation for some issues than for others. Income tax auditors look at every line item on the returns. In a few cases, auditors have concluded after some investigation that an entire audit will likely produce no change or immaterial changes. In some others, there have been no changes for a state or states. The audit schedules are set up so that the auditor will look at every item. Examples of situations in which an auditor may conclude that an adjustment will be immaterial include: a deduction for a relatively small amount, that once apportionment factors and tax rates are factored in, any adjustment would be extremely small; add back of a small amount of income to a very large base. The primary question is what is considered "immaterial." Some states advise that even a $10-$100 tax assessment is "material." Auditors typically contact the audit states if there is a big issue to be resolved. They may need to do so with a "heads up" that no significant adjustments are likely. Some states express concern when the MTC auditors don't delve deeply into their issues. Taxpayer comment: Think about the energy that a tax manager or representative must expend to get the background information on a very small item.

For sales tax audits, it is very seldom that the entire audit would be "no change." Auditors often find that for some states participating in an audit, there will be small changes or none at all. States may not fully appreciate what a joint audit requires. In the past, if the entire audit looks like it will be immaterial – MTC has closed out audits. There isn't any consistency on when that call is made. If an auditor has 300-400 hours into an audit, states will be expecting a complete audit report. Majority of cases are mostly sales tax oriented (rather than use tax), nexus plays a role here in determining materiality. Some states look to MTC to establish nexus for them because of the nationwide perspective the audit staff has. Auditors follow up on registration questions for a particular state if it looks like the nexus elements are present. Joint audit capacity is limited if the audit is focused on use tax (retailers) or if the company is very large, only have limited resources to look at documents. Some industries that are decentralized, the audit is difficult.

2. What criteria should the project team consider for making an early determination that an issue is immaterial or that no change is likely? Efficiency should be considered. Auditors should be able to balance time consumption with audit result - the amount of potential tax balanced by the number of hours that would be needed to research the issue. If a lot of time for a small amount of tax – the auditor likely wouldn't spend the time. Sometimes the auditor may be able to make a determination during

pre-audit work (review of returns); other times the auditor has to be out in the field looking at documents before making that kind of call. One option is at a point in the audit (for example: at 200 hours), the auditor could report back to the states on how things are looking. Income tax: if a company has losses or very low income, or nothing in the state – these are easier indicators to find early. If the issue is fact intensive (example: scope of a unitary business), and not enough information is available, there isn't an easy cut off point based on time in the audit. If a company is only present in a few states, that would be a simpler decision. Complexity of the federal consolidated group would make it more difficult, also a very profitable company might require more time. These factors would make it more difficult to pick a fixed number of hours as a decision point.

In sales tax, a certain number of hours could provide a good check point. For a typical sales tax audit, that would be about 16 hours per state. For sales tax, the first week is back up detail review, transcribing returns to MTC schedules; then review of the summaries takes another week. A sales tax auditor could probably make an initial call at about 200 hours. If not much is there, consider no change at that point. For some industries this would not always be applicable. (Example: real estate construction contractor.) We may need different criteria between the two tax types. Taxpayer input should be considered, or taken into account if there would be a small number of adjustments but some of them are large. (Example: taxpayer may be able to get reimbursement from client when purchases are large.) Sampling may be useful for this, too.

Each audit may have to stand on its own for what will justify a "no change" decision. Ultimately the states have to trust the auditor's judgment. Criteria will have to work for joint audits, yet still be satisfactory to the states. (Example of a no change criteria – find no significant activity in the state during the audit period.) Earlier communication might be very helpful. No news within six months after starting an audit creates expectations.

3. Should possible success on appeal be considered as one of the criteria for recommending no adjustment? General consensus after discussion is that this question should be decided by the states, not the auditors. Auditors can raise issues in the audit narrative about the strength of a position or the facts supporting a proposed adjustment, or consult the states during the audit.

4. Are many states that you have worked with reluctant to accept a recommendation that an issue is immaterial or that there is no change on an audit? Sometimes when auditor says that an item appears immaterial, the state reviewer wants to make an adjustment anyway. Some states don't appear to have no minimum threshold (not sure whether this is personal to the reviewer or is the state's policy). Typically only a very small number of states want to make adjustments that appear to be immaterial. Some want every issue to be investigated. The majority are comfortable with what the auditors are doing. In sales tax, it may depend on state law. There are a few states where the law is sufficiently different that it raises questions and requires different inquiry (example a general excise tax where interest income may be taxable item) versus a typical retail sales tax. For income tax, the audit procedures may be different – a state may have a policy or procedure that they look at every item on the return.

B. Report on information from states. After the last meeting, Greg Matson circulated a short survey to the states about their procedures for early determinations of "No change." Four states had responded as of the date of the meeting. Elizabeth summarized the results. Generally, a decision to terminate an audit or inquiry on a particular issue is made on a case-by-case basis. The auditor consults with a supervisor and documents the decision in some way. Louisiana and Utah had written materials, which they provided. The team discussed whether and how the state procedures might serve as a basis for a procedure for joint audits. A dollar threshold for a no-change audit might be useful (UT has a $500 threshold). In the past, MTC used a $200 materiality threshold and one state said that amount was still material. There is inconsistency among states about what is “material” or “immaterial.” It would help to have a dollar threshold. In Utah, once they get a completed audit report from the MTC, the state will bill the taxpayer, whatever the amount may be. If there was an understanding that there will be a no-change at a certain threshold, they could accept that. Utah’s written procedures apply only to sales tax. Utah does not require auditors to prepare a lot of documents for a no change audit. The auditor must still provide a narrative, with a check list of what was reviewed by the auditor.

At the request of the project team, Les Koenig had provided data from sales and income tax audits finalized between 2008 and 2012. He used a threshold of $1,000 as a “de minimis” assessment. The data showed that income tax audits have relatively few situations where a significant number of participating states had less than a $1,000 recommended assessment. In sales tax audits, there were a significant number in which a large number of states had very small assessments. The team reviewed the data. States under $1,000 could also be refunds, although very few would have refunds. Sales tax is difficult to get bigger assessments. Question: Do auditors scale back already when the audit appears to involve minor amounts? Les said this is true, but with a specific procedure, they could scale back sooner if issues or states are dropped earlier in an audit.

The two compliance projects (this one and audit nominations) dovetail together for sales tax. How do you find a good audit for sales tax; consider nexus issues. It is difficult to identify cross border transactions at the state level. It looks like sales tax auditors may be spending up to 1/3 of their time on cases that could be immaterial. The group tentatively concluded that these should be cleared as soon as possible to get on to the next audit. JA shared by e-mail an analysis of the numbers.

Les believes the big problem is in sales tax. It may be easier to have a no change policy in sales tax. In corporate income tax there may be issues going in both directions that affect audits in future years (example: loss carry forward). Separate entity states may need a different process from combined reporting states. (In some cases NOL carry over deductions can be reviewed later.) The auditors could explain the issue and implications for future years in the narrative. Taxpayers may expect the NOL to be audited early – need to be sure the taxpayer understands whether the NOL is being audited. In separate entity states, if an audit involves dozens of related companies, the auditor may propose to the states to audit a few companies in depth, and survey the rest. An early understanding of the scope of the audit is important for the states and for the taxpayer. Losses may not be the only issues that affect future years – apportionment factors can also have an impact in later years. Auditors can give states a heads up in their narratives about potential future years’ audit issues.

C. Develop steps for proposed process – ask the states what kind of documentation they want to see from the MTC auditor. Likely to be a copy of the general narrative, whatever data was reviewed and schedules prepared to reach that point. States may not need a state specific audit report. Could abbreviate the reports a lot once there was determined that there was no audit potential. For taxpayers – with regard to losses, very important to let the taxpayer know that the issue is not being audited so that they know it is still an open issue, especially for FIN 48 purposes – effect on the balance sheet when the issue is still open. This may need to be included in the audit manual that the taxpayer be informed. Example: not pursuing a nexus determination because of the de minimis tax effect.

Other elements of a process: need written notice of determination to the states and taxpayers that explains the conclusion and its effect on future review of the same issue; role of supervisor, Audit Director, states involved in the audit; Audit Committee; content of the final report; whether the decision is made by the auditor, or is a recommendation to the affected state or states.

IV. Assignments and Next Steps

Next meeting date: February 19, 2013

Version .5 draft process due from Elizabeth early next week.

V. Adjournment