Strategic Planning Compliance Project Work Team Session – **Early No Change**

Wednesday, April 24, 2013

11:30 a.m. to 1:30 p.m. Eastern Time

I. Welcome and Introductions – attending: Larry Shinder, MTC; JA Cline, LA; Steve Yang, MTC; Frank Hales, UT; Dave Zanone, MO; Cathy Felix, MTC; Scott Leary, MO; Gene Walborn, MT; Elizabeth Harchenko, facilitator.

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

III. Project Work

A. Review comments from Audit Committee – Team members discussed their impressions of issues and concerns from the Audit Committee meeting in St. Louis on March 7. General comments – it seemed like the process was too complex for people to understand. There are three different process areas the team had included – drop the audit; drop a state; drop an issue – this is what got a little confused. Drop an issue is good practice, but is this too much for the process? Should we stick to just the first two? One thing that is happening in the field - taxpayers are trying to get auditors/states to commit to a "no change" especially on NOLs. The documentation needs to be clear what the impact of not pursuing an issue is on future audit activity.

Terminology issue is important. What MTC calls a "survey" may be called something else in the states. Using the term "no change" seems to be really confusing people. Also, it is not clear on what the $1000 threshold applies to – one tax year or the whole audit. There was general agreement that the most significant issues are ending the whole audit and dropping a state from the audit. The real benefit of the process is at the state level and the entire audit. An immaterial issue should stay between the auditor and audit manager and not go beyond that. Look at the $1,000 as applying to the audit as a whole.

B. Update draft document – answer questions raised in issues list from Elizabeth.

Early No Change Project

Issues for consideration by project team – raised during Audit Committee meeting on 3-7-13

Issue 1 – Clarify terminology – the phrase "no change" is unclear. Consider distinguishing between a decision not to pursue an issue and a determination that the tax return is accurate with respect to an issue. Suggestions: the issue, tax year or years have "no audit potential" and the auditor will not pursue them at all (early decision to discontinue or cancel an audit); <u>OR</u> the auditor has reviewed the taxpayers records sufficiently to determine that the issue or return is accurately treated (substantive determination that no adjustment should be proposed).

We may need to define the term instead of replace the term. Definition is a good idea, but need a different phrase – "no change" seems to mean a decision that the return is correct. What this is really about is "no audit potential."

MTC Auditor did a cursory review and determined that the audit should not be pursued for one or more states. Do we need to distinguish between determination based on review of taxpayer documents and determination based on a high level review before visiting the taxpayer? LS- NOLs impact on future years need to be addressed separately.

*Conclusion: Define “no audit potential” and have it encompass both the individual tax year/state and the entire audit. Suggestion: for a named audit period there is no adjustment for a particular tax year or state.

Issue 2 – Consider dropping references to a single issue – several people stated that it is just good audit practice to make decisions early in an audit that some issues are not worth pursuing (either they look reasonable or the potential assessment/refund isn’t enough to justify the work needed to document the adjustment). It sounded like the states generally don’t give a list of unreviewed issues to taxpayers. There seemed to be some agreement that if a single issue affected most of the states in the audit, some kind of consultation or notice would be expected. [Question for the team: is the MTC audit practice to prepare schedules that show every line item from a return, whether or not there is an adjustment? If so, is this practice really needed? Could it be changed so that schedules show only the adjustments that are proposed?]

This may be too much into the guts of the audit process. State expectations were inconsistent in the Audit Committee. Q is there a list of issues when the audit is started? MTC has authority to look at all the companies in the combined return and to look at all issues on behalf of the states. Key issues typically are unitary, business/non-business, apportionment factors, NOLs. Audit schedules show every line item of the return, narratives have an element for every line item on the return. Auditors may currently document as “materially correct” or “no material adjustment noted.” For sales tax, if MTCF recommends that a state forgo a use tax issue, can note that taxpayer has no physical presence or employees (verified), and include this in the narrative. Group agrees that we were focusing on early determination on whether to do an audit. Single issues are typically auditor judgment. If addressing single issues in the procedure isn’t going to save auditor time, then we shouldn’t address it. Time savings is in loss years.

*Team agrees to drop references to single issues – audit supervisors should be monitoring these decisions. Encourage early communication with the states by the audit staff.

Issue 3 – Communication – Two themes here: early communication with the states to address any procedural requirements for notice to taxpayers; and the need for a clear description of content of any communication with taxpayers, both for the effect of the auditor’s determination and the likely action by the states after the MTC audit is concluded. Auditors need to be assured that the states have a clear understanding of how the auditor will be conducting the audit so that the states don’t ask to reopen an issue after the audit reports are done. If auditor is not going to propose a small refund, the auditor needs to let the state know in case the state has an obligation to issue a refund without an amended return from the taxpayer. [Question for the team: do you want to ask the states how many have “taxpayer bill of rights” that address whether the state must issue a refund that is determined to be due, without an amended return, if an audit would result in a refund.]

We need to clarify when the notice is given to taxpayer – it should be at the end of audit. Taxpayers expect that MTC audit (completed) covers all the states that were included initially. Auditors don’t know what they would find until they are finished with field work. Taxpayers were interested in knowing whether a state would be pursued; we should be cautious about telling the taxpayer too soon and then having a different final result.

*Team agreed to change the order of language in Notice Procedure (3) – notice in final report unless with agreement of the state(s). Exceptional issue – such as dropping a group of states because of no combine reporting issues, could be handled differently if that makes sense.

Issue 4 – Materiality Threshold – The states seemed comfortable with $1,000 as a threshold for corporate income tax. [Question for team: Should the threshold be different for sales tax, since these audits don't results in large overall assessments?] Exception noted for nexus issues – question for team: do you want to express materiality differently if the primary issue in an audit is filing/nexus for many or most of the states? Exception noted where there is an issue that is similar for many states, and it takes little or no extra work to develop a proposed adjustment that work result in less than $1,000 for a few but more for others. A question arose whether the $1,000 material threshold applied to a single issue, a tax year, or the whole audit for one state. Issue: what if there are offsetting adjustments? For sales tax assessments in some states, if the total assessment is less than $1000 auditor is encouraged to drop the audit (sales tax) so long as taxpayer corrects the treatment in the next return. Income tax – the $1,000 threshold was for the entire audit for the state, not just for one year. If there are big offsetting adjustments, supervisor should make the call. Sometimes the nature of one issue may have precedential value even if there are other issues that are one-time events that offset; need to have the adjustment be proposed. Need to reword the guideline to recognize the potential effect on future returns, and don't have the threshold apply in that case.

*Team agreed to use the threshold as a guideline but not as a hard and fast rule. This also goes back to communication about the issues to the state and taxpayer. There may be exceptions in special circumstances.

Issue 5 – Documentation required – if the auditor proposes that an entire year be closed without a full report, documentation should include what tests were done to come to that conclusion, what issues were examined and how were they resolved. Auditor should address specifically the issues that were identified to support putting the taxpayer in the audit inventory. Need to have specific documentation of any issues that might affect subsequent years (loss carry over; credit carry over) even if no adjustment is proposed for the years under audit. A check list might help. Current MTC practice is to do a narrative that describes what the auditor did and how auditor reached conclusions. For sales tax, MTC has a 2-page document that is a check list of items, sees this as useful, narrative also goes into detail about what the auditor did. We have to recognize that it takes time to get comfortable with abbreviated reports. Q-for income tax do the auditors have an issues list? MTC's schedule templates are designed for all line items. They could standardize the reporting schedules.

*For the states in corporate audits, want general audit narrative and general schedules, but would not get state-specific schedules or a state-specific audit narrative if the state was dropped from the audit.

C. Decide whether to seek more comment– from whom and how to solicit, deadline for comment. Defer until see a new draft. May want to discuss how process works specifically with sales tax states.

D. Review project description – (1) have we covered all the issues identified?

Issues for review:

- Should the MTC Audit Program have minimum standards or criteria for completing full audit report for each state participating in an audit, even if there is very little or no change to the tax returns for a participating state? Yes.

- Do any states have legal constraints that must be considered in determining materiality or the documentation required for a tax audit? None noted by the states.
- What standards should be applied to determine whether an MTC auditor can make, or recommend, a “no change” determination for a state during the course of an audit? Done.
- Are there any existing MTC policies or procedures that would have to be changed if an early “no change” process is developed? May need to develop new internal procedures and reports; but there are no current policies or procedures that conflict.
- If an early “no change” process is developed, should it be different in any way for Sales/Use tax from Income tax? Report/documentation is different; process is not.
- Would a “no change” audit process affect state participation in audits? If so, how? Team opinion: Not likely.
- What efficiencies (time or cost) could be obtained by using a no change process? Auditor time, state time and taxpayer time.

Expected outcomes from the project:

- Process by which MTC auditors can make an early “no change” determination and communicate that to participating states. Done.
- Standards for making an early “no change” determination. Done.

IV. Next Steps – next meeting date: last 2 weeks of May.

To Do items: New draft out by May 1.

V. Adjournment