

# Unexpected Audits...Why is This My Problem?

## Panelists

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# So, Why Is This Your Problem?

- “Send it to the Tax Department – they handle audits.”
- And perhaps for good reason – no one has more expertise in handling audits and assessments than the Tax Department.
- The Tax Department may not be responsible for the filing or reporting of a specialized tax or fee, but if something goes wrong, it often lands on the Tax Department.

# Today's Agenda

- Help prepare you and your team to tackle some specialized/unusual taxes or fees when an audit or assessment lands in your inbox.
  - Is it a Fee or Tax?
  - The Administrative Procedures Act
  - Beyond The Tax Agency
  - Examples of Specialized Fees/Taxes

# Is it a Fee or a Tax?

- Taxes are usually in the nature of a “general” tax for the “general” fund – Revenue Power.
- Fees are usually in the nature of a “user fee” and are sent to designated funds – Police Power.
- Why does it matter if it is a fee or tax – the governing agency, audit process, sampling methods, information requests, and appeal rights/process can all differ for fees vs. taxes.
- Identifying factors include: What is it called? What agency is it administered by? What triggers imposition of the fee/tax? Where does the revenue go?

# Administrative Procedures Act

- **Federal “APA”** - Title 5 USC Chapter 5, Sections 551 - 559 (most states have a state APA that *usually* parallels the federal APA).
- Agencies have great flexibility due to their specialized purpose; however, the APA provides a framework for Due Process safeguards on administrative actions.
- Rule Making [APA Sec. 553]: To “promulgate” a rule, the agency must provide:
  - (1) Public Notice: Time, Place, Purpose – usually 30 – 60 days / Official Register;
  - (2) Opportunity to Participate - submit views - *but* submissions are public record;
  - (3) Effective Date of Rule Adoption – at least 30 days – retroactively permitted?

# Administrative Procedures Act

- BUT – State agencies can sometimes be exempt from portions of the APA - For example, in many states the APA applies to the Department of Revenue – but the adjudication provisions do not.
- Ruling Making Record - Most APA statutes require retention of an administrative rulemaking record that is available to the public (like legislative history). The burden is on the agency to show they promulgated a rule properly. Many challenges to an administrative rule focus on whether the rule over exceeded its stated purpose. **Careful, .....comments are usually public.**
- Adjudication [APA Sec. 554 / 556]. A hearing with an Administrative Officer or ALJ resulting in a “proposed decision”, “decision”, or “order”.
  - Is your case being heard by an agency employee, or an ALL? 5 USCA 3105. Ex Parte Communications rules will differ. [ APA 557]
  - Most state APAs exempt DOR tax cases – but, if a fee it is likely a different agency that is under the APA’s adjudication process.
  - Burden of proof in tax cases is on taxpayer, but under the APA it may be on the Agency. [APA 556]

# Administrative Procedures Act (con't)

- Information to the agency – often rather than a typical audit request, many agencies simply issue subpoenas as their normal procedure enforceable in the courts. Call the agency if you feel the subpoena is too broad or burdensome. [APA Sec. 555]
- Sometimes hearing decisions are public, but usually permit redactions.
- The decision will typically give instructions on how to appeal – Consider  
(1) Scope of Review [APA Sec. 706] and  
(2) Establishing Factual Record.

# Administrative Procedures Act (con't)

- Take Away: Look to the APA if the “process” is suspect.
- Rulemaking challenges often focus on whether the rule exceeded the agency’s legislative authority, whether the rule was properly promulgated, or the rule is within the scope of its purpose stated in the Public Notice. Adjudication challenges to the *process* are difficult. Instead, look to the rulemaking record relied on for insight to interpret its meaning. Consider if the rule is “legislative” or “interpretive.”



# Administrative Procedures Act (con't)

- Almost always a second level of administrative appeals is provided – to a tribunal panel, Administrative Law Judge, or the Agency Commissioner.
- In particular, pay attention to the “record” you are making. Typically, the judicial rules of evidence for developing the record are far less stringent.
- Other APA provisions that might be helpful: (most states parallel)
  - Freedom of Information Act “FOIAs” (letter rulings, audit manuals) APA Sec. 552
  - SUNSHINE LAWS / Open Meetings Act (APA Sec. 553-b)
  - Conflicts of Interest for the Hearing Officer. APA Sec. 556

# Beyond the Tax Agency

- **Qui Tam / Whistle Blower / State AG Investigations/ Others**
  - Authorizes private individuals to initiate lawsuits to combat allegedly fraudulent claims made to the government.
  - In 2010 New York amended its False Claims Act to allow for tax whistleblowers (private plaintiffs) to bring lawsuits against individuals/entities for fraudulent tax claims.
  - The net income or sales of the taxpayer against whom the claim is brought must be at least \$1 million for any tax year subject to the action. Further, the damages asserted must exceed \$350,000.
  - When a civil qui tam action is brought under the NY FCA, the AG may convert the action into an enforcement action, intervene in the action, or move to dismiss the action.
  - Depending on whether the AG decides to intervene, the qui tam relator is entitled to various percentages of the proceeds recovered if successful .

# Beyond the Tax Agency

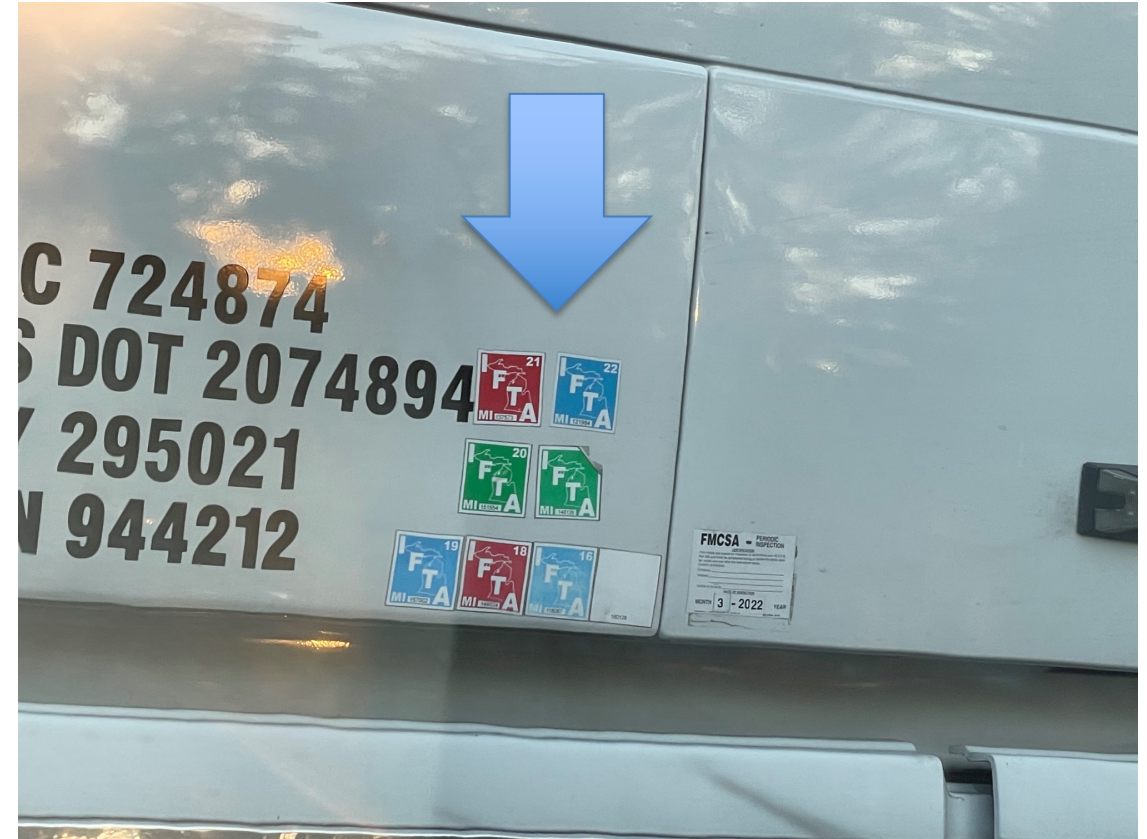
- Class Actions
  - Wayfair effect on class actions.
  - How states have worked to protect retailers.
  - Uptick in Consumer Protection/Fraud Actions.
- Considerations in these circumstances
  - Hiring an attorney.
  - Special statutory and/or civil rules may apply.
  - Penalties are often very high with these types of special actions and liable for statutory damages/counsel fees.
  - Ask the Department of Taxation to intervene?

# Examples of Special Taxes/Fees

## Occupational License and Payroll Taxes

- Local taxes outside the jurisdiction of the state taxing authority; called “fees.”
  - Example: In Kentucky, can be imposed by a city, county, school district, and/or special taxing districts such as fire, EMT, and agriculture districts.
  - Important to know which jurisdiction you’re working with.
- Primarily focused on payroll as opposed to net income.
- Common Issues
  - Remote Workers.
  - Employees living in one jurisdiction and working in another.
  - Common paymaster difficulties.
  - In complex corporate structures, determining which/how many entities are subject to the tax.

# Examples of Special Taxes/Fees



# Examples of Special Taxes/Fees

## **IFTA Fuel Taxes - International Fuel Tax Agreement**

- Fun Fact: States are constitutionally barred from entering into compacts governing commerce without Congress' approval – i.e., the impetus of taxpayer challenges to the Multistate Tax Compact and Commission.
- IFTA is one of the first, and perhaps only, Multistate Agreements covering taxes that has been approved by Congress.
- It is an interstate agreement on collecting and distributing motor carrier fuel taxes under the National Governors Association via allocating fuel taxes paid based on miles traveled in the state.



# Examples of Special Taxes/Fees

## IFTA Fuel Taxes - International Fuel Tax Agreement (con't)

- The audits are “conducted” by a respective state’s Department of Revenue, but audit calculations are often confusing and handled by ITFA administrators.
  - The audit compares what was reported to the state vs. their calculation.
  - Interest is imposed on underpayments, but not overpayments
  - Appeal starts with state of registration, but any member state can appeal and re-audit within the six-year statute of limitations.
- IRP (International Registration Plan ) 49 USC 31702 – IFTA’s sister statutes but not the same

# Examples of Special Taxes/Fees

## Environmental/Storm Water/Fees and Permits

### Storm Water Fees

- Impervious vs. pervious property
- Rail industry 4R claim considerations

### Street Sweeping and Street/Parking Lot Light Fees

- Intended for store frontage beautification and clean up
- Who benefits?

### Business Licenses

- Is it applicable? Interstate Commerce may already grant the right to do business.

Note: Is it Worth the Fight?



# Examples of Special Taxes/Fees

## Independent Contractor

- Contractor is and shall remain an independent contractor in performing the Work under this Contract *a shall Determine the manner and means by which results are to be obtained and shall maintain complete control* of its workers and operators incident to the proper performance and completion of this Contract, including that of its subcontractors, agents and assignees....
- Contractor agrees, represents, and warrants that Contractor will pay all *withholding tax, social security, Medicare, unemployment tax, worker's compensation* and other payments and deductions (including *garnishments...*).

# Examples of Special Taxes/Fees

## **Independent Contractor Re-Classifications to Employees – Potential Challenges**

- Very Complex – and involves multiple agencies, each with their own rules and which act independent of the other agencies and their determinations.

### **Unemployment Insurance, Income Withholding, Wage & Hour, Benefit Plans,**

Can impact your general accounting for expenses and taxes due.

- A single worker re-classified can impact that worker AND “others similarly situated.”
- Burden of proof is on the Company, the presumption is all workers are employees.
- These are VERY fact intensive challenges – know the agency you are dealing with.
- Common Challenge Areas: Contractors indefinitely working at your company.
- The IRS and most states use the “Common Law Test” for determining employees v. contractor status.

# Examples of Special Taxes/Fees

## Worker's Compensation "Fees" / "Tax" / Assessments

- Not within the tax agency
- "The Right To Control Test" – how much can (not actually does) the employer control the worker's work, tools used, hours, right to hire and fire, etc. Common Tests: A-B-C Test, Economic Reality test, Common Law test

# Examples of Special Taxes/Fees

## State Unemployment Insurance “Fees”

- Not within the tax agency.
- “ABC Test” - To be an independent contractor, the worker must:
  - **(A)** be free from the *employer’s direction and control* - this is why you often see contracts mention “deliverables
  - **(B)** the work must be performable *outside the employer’s premise?*; AND
  - **(C)** the individual is *customarily engaged* in an independently established business .
- Ultimately, all the factors are the same, it is just that the Common Law Test is an “all-in” test whereas the ABC test and Right to Control Test is very limited and requires several “and”s in their tests. Often it is very difficult to pass the ABC test (that is it is difficult to avoid an employee classification), not just because it is more stringent but also because the agency has very wide discretion to interpret the requirements.

Cases Abound – Common Services Challenged: Hairdressers, Truck Drivers, Janitorial, Traveling Salesperson.

# Examples of Special Taxes/Fees

## Other Important Items:

- UI, WC and W&H: All over the map. The agency's dispute/protest rules likely parallel the APA.
- Usually hearings are decided by agency's Hearing Officers.
- Hearing Officers give heavy deference to the auditor.
- There is a **heavy** presumption in favor of "employee" status.
- Burden of proof is on the "employer" to prove they are not an employer
- Although different agencies within the same state apply different tests, they will tend to follow each other's final decisions.

# Examples of Special Taxes/Fees

- Do not treat a single individual's case as insignificant because an agency's decision often covers "those similarly situated."
- Make sure you are given the resources to handle the audits ("reports") and appeals. The assessments can be large, it can impact HR Benefit Plans as well as accounting for wages.
- Keep a list of outside advisors who have dealt with the agency. These audits and appeals tend to move quickly.
- Watch procedure, the agencies sometimes don't follow their procedures

# Examples of Special Taxes/Fees

## UI Rate Transfers – A Common UI Sub-Issue

- Acquisition considerations – could the purchase of a business leave you with the UI tax consequences?
- Example: In Kentucky, an entity will be considered a successor for rate purposes if:
  - Negotiation occurred; and
  - At least two (2) of these conditions are met, unless only (c) and (d) are met:
    - (a) The employing unit was a going concern at the time negotiations for the transfer began;
    - (b) The subsequent owner or operator continued or resumed basically the same type of employing unit in the same location;
    - (c) The subsequent owner employed fifty (50) percent or more of the previous owner's workers in covered employment;
    - (d) The previous owner employed fifty (50) percent or more of the subsequent owner's workers in covered employment; or
    - (e) The subsequent owner acquired work contracts or commitments from the previous owner.

# Examples of Special Taxes/Fees

## Insurance Taxes

- Tax imposed on insurance premiums; usually collected and remitted by the insurance company.
- Important to understand at the outset where the policy originated, where it was handled (if different), and where is the risk located.
- Must understand what the law is in each one of those jurisdictions.
- For example, Kentucky imposes insurance tax liability based on where the risk is. So, even if a policy carries an Ohio address and is managed out of Ohio, if the risk is located in Kentucky, the Company may owe Kentucky Insurance Tax.
- Can be imposed by cities, counties, or state insurance departments, so understand which agency is conducting the audit.



# Thank You

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