

30th ANNUAL

PAUL J. HARTMAN  
STATE AND LOCAL TAX FORUM

# State Audits and Controversy: Where the Rubber Really Hits the Road!

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## Session Objectives

- How to prepare for a state audit by having a great defensive plan.
- How to go on the offensive to either defend your audit position or provide a counter audit position.
- How to reach an “acceptable” settlement and, if not available, to fight to the bitter end.
- How to protect confidential information.

# Develop an Overall Strategy

## Issues

- Develop a strategic and repeatable pre-audit checklist
- Identify all potential audit issues
- Narrow these issues
- Identify “Trade-Off” issues
- Evaluate where the issues may be resolved:
  - Audit
  - Refund claim
  - Informal Conference
  - Hearings/Litigation

# Develop an Overall Strategy

## Pre-Audit Checklist

- Identify and document known audit issues.
- Develop taxability positions and filing positions to evaluate their strengths.
- Review reserves and/or underlying documentation associated with audit issues.
- Identify the audit team and experience level.
- Discuss internally where audit focus will be.
- Consider available opportunities to minimize tax exposure.

# Develop an Overall Strategy

## Pre-Audit Checklist (cont'd)

- Make sure returns properly reflect your legal positions
- Evaluate best methodology for your company (block, sample, stat sample)
- Review prior audit file
  - What adjustments or negotiations were made?
  - How was the previous audit resolved?
- Understand which issues are likely to be resolved at audit vs. administrative level

# Polling Question 1

You're worried about potential tax exposure on audit. How can your tax department and/or legal department provide value at the pre-audit stage?

- A. Identify potential audit issues and consider how they may be resolved.
- B. Consider possible IDRs on issues of concern and how best to respond.
- C. Review prior audit workpapers and audit results and be prepared to address those issues during the current audit.
- D. All of the above.

# Develop an Overall Strategy

## Before the Audit Consider the Following:

- Potential audit issues
- Prepare supporting documentation to support filing positions
- Compile the thinking and analysis that support the filing position
- Ensure that your returns properly reflect your legal positions
- Evaluate whether any refund opportunities exist to offset any potential deficiencies

# Develop an Overall Strategy

## Before the Audit (cont'd)

- Review state information regarding audits, documentation expectations, and authority to evaluate and negotiate items
  - Examples: Support for incentives claimed, transfer price study review, and legal analysis
- Review reserves or underlying documentation associated with audit issues
- Assess exposure at high level

# Develop an Overall Strategy

## Before the Audit (cont'd)

- Your company should maintain standard procedures for handling state and local tax audits (HINT: rely upon your company's pre-audit checklist)
- Standard procedures should address:
  - Audit workplans, and when and how to use them
  - Statute of limitations waiver policies
  - Document retention policy
  - Provision of documentation to auditor
  - Protecting privileged documentation
  - Staffing:
    - Who will be responsible for the audit and who will support that person and/or team?
    - Consider use of experts, consultants, and outside counsel

## Polling Question 2

Which of the following issues are most likely to be resolved at audit?

- A. Issues of pure fact
- B. Issues of a mix of both of fact & law
- C. Issues of pure law

# Develop an Overall Strategy

## In the Age of the Internet...

- Know what about your company is available to the auditor:
  - What We Sell
  - How We Bill It
  - YouTube Videos
  - Our terms of service
  - It's on our Website?!?
  - SEC filings
  - Marketing Materials
  - Business Articles

# The Audit

## Starting the Audit on the Right Foot – Opening Meeting

- Schedule “kick-off” meeting with auditor
  - Be aware of any agency regulations or notices that address how audits are to be conducted
- Establish audit ground rules with the auditor after your company has established its internal procedures
- Your company should:
  - Convey your SOL waiver policy
  - Request that all IDRs and questions be in writing
  - Communicate any timing issues (e.g., busy times)

# The Audit

## Starting the Audit on the Right Foot – Opening Meeting (cont'd)

- Discuss scope of audit, expected time frame, expected information needed
- Discuss lines of communication with auditor
- Discuss whether the audit will be a field or desk audit
- Discuss where and how information will be provided to auditor
  - At client site? Representative's site? Mail/email? Third-party drop site?
- Be clear whether auditor may take or copy information viewed on-site; consider privacy issues (e.g., subscriber bills, corporate minutes or agreements with proprietary content, etc.)
- Be clear if there is certain information you cannot provide

# The Audit

## Starting the Audit on the Right Foot – Rules of Engagement

- Be nice
  - A “make life difficult” strategy doesn’t work and is expensive
  - Always be respectful to auditors
- Be helpful
  - Work with the auditor to get all the factual information correct
  - Make on-site visit productive by preparing materials in advance
- Be firm
  - Make it clear if there is certain information that you cannot provide
  - Explain privilege and work product protection; waiver consequences
- Be present
  - In-person meeting with a Department can pay dividends in arriving at an understanding and closing an audit

# The Audit

## **Audit Information Requests – Always get information requests in writing!**

- Before responding, determine the format of the response
- Assess whether the request is asking for
  - Confidential information
  - Proprietary information

# The Audit

## Developing Solid Audit Procedures

- Maintain an audit workplan
  - Creates accountability for both parties
  - Eliminates uncertainty regarding the scope
  - Reduces risk of delayed or stalled audits
- Preserve audit log (this should be in writing)
  - Track correspondence and audit information exchange
  - Copy of all documentation provided should be retained
  - Statute waiver log
  - Document delays

# The Audit

## Managing Stalled Audits

- At some point during audit, audit may stop moving audit forward and/or become unresponsive
- Audit procedures should consider:
  - Will company initiate contact?
  - If not, how long will company wait before considering the audit closed?
  - When can ASC 740 reserves be released?

# The Audit

## Audit Management – Audit Workplan

- Audit workplan should address:
  - Scope of audit
    - Companies being reviewed
    - Types of tax subject to audit
    - Issues being audited
    - Tax years being reviewed
- Timeline for completion
- Process for review of documentation
  - On-site or off-site?
  - Do some reviews need to be supervised?
  - Will auditor have access to make copies?

# The Audit

## Strategies for Minimizing Audit Sample

- Having the most concise population of transactions will lead to the most concise sample
  - Removing offsetting debits and credits is a good first step
  - Removing accounts that have no tax consequences
  - Same goes for transactions types, vendors, states, etc. – remove or set to the side anything that’s simply not germane to the audit
- A little extra population analysis up front will save time during the audit process for both the taxpayer and the auditor

# The Audit

## Managing Documentation and Information Provided

- Internal procedures established pre-audit should dictate:
  - Use of an audit log
  - Retention of copies of all correspondence with the Department (e.g., IDRs, responses, etc.); consider bates labels
  - Avoidance of duplicative production and inconsistent responses by cross-referencing IDRs

# The Audit

## Managing Documentation and Information Provided (cont'd)

- Verbal IDRs
  - Either ask the auditor to put the request in writing or you put it in writing to the auditor stating what you understand is being requested and when the information or documentation needs to be provided
- Focus inquiries
- Maintain a record: Failure to provide documentation/evidence during the audit may preclude reliance on evidence at a later point
  - *United Parcel Services General Services Co. v. Dir., Div. of Taxation*, 25 N.J. Tax 1 (N.J. Tax Ct. 2009): Taxpayer's right to appeal was limited to whether the auditor's determination was reasonable in light of the information available at the time of audit
- Balance responsiveness with protection of taxpayer rights

# The Audit

## To Sign or Not to Sign (Waiver Agreements)

- During audit, state will likely ask taxpayer to agree to extend SOL
- Know the current SOL and whether the SOL is impacted by other SOL for the same tax periods.
- What is your policy for extended the SOL? Weigh the benefits and risks.
- Ensure waivers address both assessment and refunds.
- Consider length of the waiver. How hard do you push back?

## Polling Question 3

What is your company's policy on granting statute of limitation extensions?

- A. Always grant an extension
- B. Never grant more than one extension
- C. Never grant an extension
- D. Extension depends on the facts and circumstances of the audit

# The Audit

## To Sign or Not to Sign – Policies Regarding Extensions/Waivers

- Company's audit policy should provide a reasoned approach regarding whether it will grant SOL waivers
  - Granting an SOL waiver:
    - Limits risk estimated assessment and allows time for resolution of factual issues
    - Maintains goodwill as both taxpayer and state seek to keep audit moving toward resolution on reasonable timeline
  - But granting waivers may result in unnecessary delays (and increased interest)

# Specific Audit Issues

## Multistate Issues

- Develop a multistate strategy for dealing with multistate issues; imperative to address early in the audit process and prioritize jurisdictions
- State information sharing has increased the likelihood of multiple state assessments

## Sourcing Procedures

- Understand laws regarding sourcing of your product for tax computations in jurisdiction under audit and more broadly
- Understand company's basis and documentation for sourcing sales

## Control Your Data

- Sales and use tax audits are often about the data and how good it is
  - Know how a transaction is recorded in the GL
  - Determine how to provide a reconciliation

## Resale Certificates

- Have good policies in place to avoid nasty surprises regarding insufficient resale certificates

# Ending the Audit: Closing Agreements

## Button Up the Closing Agreement

- All settlements should be memorialized in a written closing agreement
- Settlement agreement should be viewed as a contract
  - *Sono Equities LLC v. City of Norwalk*, No. CV-09-4016818S (Conn. Super. Ct. 2011): Denied a motion to enforce a settlement agreement because a series of emails between the property owner and the assessor did not evidence a “meeting of the minds” between the parties
- Consider who has authority to approve/sign an agreement

# Ending the Audit

## Considerations for Closing Agreements

- Issue-by-issue versus dollar settlements
- Methodology used
- Impact on future periods and audits, including impact of future law changes
- Impact on tax attribute carryforwards
- Impact on other members of affiliated group (if separate reporting state)
- Confidentiality of terms/state information sharing

# Litigation: Develop an Overall Strategy

## When Do You Begin Preparing for Litigation?

- Recognize an issue that potentially leads to litigation;
  - As early as when a transaction is contemplated or planning technique employed
- Not upon the issuance of an assessment
- When a return position is taken

# Litigation: Develop an Overall Strategy

## Pros and Cons of Litigation

- Cost vs. Benefit
- Court or Elective Earlier Procedure
- Choice of Forum, including venue consideration
- Summary judgment vs. evidentiary hearing-  
pros and cons
- Are there constitutional issues?
- Potential impact on other states
- Potential impact on competitors

# Litigation: Develop an Overall Strategy

## Settlement

- An opportunity to settle is almost always available
- Generally, the earlier in the process the better
- Concerns with settlement discussion

# Litigation Preparation

## Notice of Assessment

- Establishes the Department's prima facie case as to both the basis for and amount of the assessment
- It is the taxpayer's burden to establish by competent evidence that the Department's assessment is incorrect
  - What if the assessment is based on erroneous facts?

## Options/Strategy

- Concede and pay the assessment
- Pay and file a refund claim
- Prepare and timely file a protest
- Pay under protest

# Litigation Preparation

- Engaging outside counsel
- Collecting supporting documents
- Identifying potential fact and expert witnesses
- When to (or try to) to stipulate to facts
- The Complaint or Protest – how detailed should it be?
- Discovery (if available)
  - When should taxpayer issue discovery
  - What types of requests for discovery should taxpayer issue
  - Use of FOIA requests
  - Depositions

# Litigation Preparation

## Trial Considerations

- Pre-trial briefs
- Type of witnesses
- Affidavits – if permissible, should they be used?
- Use of Stipulations

# Evaluation of Forum Selection

## Administrative Review

- Tax need not be paid until there is a “final determination” – interest accrues
- Further opportunity to understand the state’s position
- Rules of evidence may be less restrictive
- Lack of independent hearing officer
- Not a public decision
- Appeal result is an additional level of review
  - Need to determine the standard of review
- May be required to proceed to court action

# Evaluation of Forum Selection (cont'd)

## Claim for Refund Action

- Interest stops accruing v. time value of money
- Evaluate where the matter will be resolved – Administrative Body vs. Court
- Strategy: Timing of litigation & State of litigation

## Payment and a Court Action

- Impartial judge
- Rules of evidence apply
- Eliminates a level of review
- Appellate Court review

## Disadvantages of a Prepayment Action

- Interest continues to accrue at statutory rate
- May be required to post bond or security (e.g., TN Chancery Court)

# Protecting Confidential Information

- Attorney-Client Privilege
- Work Product Doctrine

# Attorney-Client Privilege

- Protects confidential communications and documentation between an attorney and a client primarily related to providing legal advice
  - Where legal advice of any kind is sought from a professional legal adviser in his capacity as such, communications relating to that purpose, made in confidence by the client, are permanently protected from disclosure by the client or the legal adviser, except if the protection is waived.
- Absolute protection against disclosure
- Client may waive the privilege intentionally or by disclosing communication(s) to third parties or by persons without a need to know

# Attorney-Client Privilege

## Who Can Invoke Attorney-Client Privilege?

- “Control group” of management employees in position high enough to decide upon action or act upon advice of attorney; or the matter is within scope of employee’s duties
- Employee who possesses information not available to upper level management
- Employee who has authority from superiors to secure legal advice

# Attorney-Client Privilege

## What In-House Counsel Needs to Know

- Must be acting in the capacity of a professional legal advisor
  - Must have an active license
- Privilege does not extend to communications made for purposes of involving business or financial advice, making business judgments, or assessing business risks, even if made by an attorney
- Because in-house counsel is frequently enmeshed in business decisions, legal and business advice from in-house counsel must be clearly labeled and separate

# Attorney-Client Privilege

## What the Tax Staff Needs to Know

- The corporation is the client and holds the privilege
- Not every employee can establish the privilege for the corporation
- In-house counsel should advise and establish, where appropriate, the basis for shielding or protecting confidential documents
- Not everything told to an attorney who represents you or your company, or what that attorney tells you, is privileged and not subject to discovery
- Attorney must be acting in a professional legal capacity
- Communication(s) must relate to the legal advice sought

# Attorney-Client Privilege

## What the Tax Staff Needs to Know (cont'd)

- Privilege extends only to appropriate communication(s) and not to facts
- Tax returns and supporting documentation generally are not privileged
- Requests for legal advice should be clearly stated and labeled as privileged

## “Work Product Doctrine”

- Complements the attorney-client privilege protection
- Protects the tangible work product of attorney, or those assisting an attorney, related to and prepared for or in anticipation of litigation, including notes, workpapers and memoranda
- Extends to documents provided by outside experts and consultants if such persons are engaged to assist counsel and are under counsel's supervision
- Although it is not necessary that litigation has commenced, the doctrine presupposes either that a claim or actionable facts exist, or minimally that the motivation for the privilege documents is the prospect of reasonably foreseeable litigation
- The privilege can be waived or lost, similar to attorney-client privilege, but generally only by voluntary, not inadvertent, disclosure.

# “Work Product Doctrine” Applied to Tax

- The advent or prospect of a tax audit is typically not sufficient basis for work product privilege, as the purpose of the audit is to assess tax liability, not to prepare for or conduct litigation.
  - Remote possibility or mere speculation of litigation does not give rise to the protection. Factors include:
    - Whether the legal issues in dispute and the adversaries are identified at time documents prepared
    - Proximity of time between preparing materials and filing of litigation

# Protecting Confidential Information

## General Conclusions and Take-Aways

- Make sure that litigation risk analyses are clearly labeled as being privileged
- Keep privileged documents separate
- Involve counsel in the preparation of privileged documents
- Keep documentation explaining why a document is deemed to be privileged and that it was prepared in anticipation of litigation
- Workpapers should be as "lawyerly" as possible
- Mere preparation of a tax return is viewed as accounting work, and not entitled to work product protection simply "by hiring a lawyer to do the work that an accountant, or other tax preparer, or the taxpayer himself . . . normally would do."
- Written agreement from outside auditors can generate additional strength

Thank you for your time and attention.

Q&A

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