TAX MANAGEMENT

WEEKLY STATE TAX REPORT

January 22, 2010

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Procedure

At a time when state auditors are increasingly aggressive, it may be more important than ever to stand firm regarding tax reporting positions. With states facing another round of billion-dollar budget shortfalls, it's no accident that auditors are issuing arbitrary or even bogus assessments, according to Geoffrey J. Christian, of Dow Lohnes Price. In this article, the author explains why taxpayers should resist the urge to settle such ''nuisance'' audits quickly, even when they involve relatively small sums or difficult fact patterns.

Are Your State Audits Ridiculous? It's Time to Push Back! A Primer on Handling Arbitrary or Bogus Tax Assessments

BY GEOFFREY J. CHRISTIAN

INTRODUCTION

Are you tired of state auditors being so inflexible? Are you frustrated when state auditors and supervisors push things to the next level just because they can? Does it really grate on you when you are forced to pay something in settlement to a state on an issue that, for all practical purposes, is black and white? Well, it may be time to start pushing back. Sure, this ''push back'' approach is not recommended in every case, and while other tax and nontax reasons often exist to support settling cases, settlement for settlement's sake is not always your best long-term strategy.

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With state auditors being increasingly aggressive during these economic times, it may be more important now than ever to stand firm regarding your tax reporting positions. In the current environment, state auditors seemingly issue assessments like someone throwing mud on the wall, hoping that something will stick. Whether they do this to meet a job quota, or because they are forced to by their supervisors, or to otherwise compensate for state budgetary shortfalls, companies are often faced with assessments where the state has not fully developed the facts and for which there are little or no grounds for the assessment.

For example, our firm recently represented a client where the state auditor assessed income tax on the dis-

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allowance of management fees/overhead expenses charged by a parent to its subsidiaries based on legitimate and proper allocation methodologies (gross receipts, employee head count, and square footage). The auditor contended that the expenses would only be allowed if invoices accompanied by proof of payment were provided. How many companies actually issue invoices for intercompany management fees, valid or not? Unfortunately, this example is not isolated. Over the past several years, we have seen many other similarly outrageous situations, including unclaimed property assessments on statutorily exempt transactions (business-to-business transactions, gift cards), sales tax assessments based on improper sampling, and the disallowance of bonus depreciation subtractions for a company that appropriately added back federal bonus depreciation in prior years, to name a few.

THE STATE'S VIEW OF AUDITS

From the state's perspective, the issuance of more assessments is akin to generating additional leads in the sales funnel of a profitable business enterprise (or, perhaps it's more analogous to increasing your lottery odds by purchasing more tickets—except the ''tickets'' are free to the state). Once an assessment is issued, regardless of the level of support for its position, the state recognizes and relies on a certain percentage of these assessments to come through the bottom of the sales funnel as additional revenues for the state. In essence, the states know they can generally collect a certain percentage of all assessments outstanding. Accordingly, it seems as though if a state auditor can dream up some position to justify an assessment, no matter how lame, the state has a high probability of getting something out of it.

Why are the states so successful in this approach? A number of reasons: First, states know that many companies simply don't have the time to deal with arbitrary assessments. As a result, companies will often offer up an overly generous settlement amount to resolve the case. This gets the issue off the table and minimizes internal time spent. Furthermore, states know that many companies do not have the in-house resources to draft protests, position papers, and legal briefs to fight an assessment. In both of these instances, the company may decide to offer in settlement what it might expect to pay a service provider to draft the appropriate legal response or to ultimately fight the assessment. However, while the battle may be won with this approach if the state accepts the offer, it's possible in some instances that the company is, in fact, losing the war.

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Another reason states are successful in raising dollars through such arbitrary assessments is the historical certainty that most companies are not going to ''go the distance.'' States rely to a significant degree on the fact that most companies will not take an issue to court. This works to the states' advantage. If a state knows the taxpayer is not likely to file a petition in court, a significant amount of the taxpayer's negotiating leverage has just vanished.

While a state can threaten to push issues to the next administrative appeals level very easily, taxpayers are often left between a rock and a hard place. A company choosing to fight the battle must be prepared to incur the costs and expend the resources necessary to do so. Alternatively, a company can choose to pay the assessment, or some portion thereof, in resolution of the case, but again, costs are involved. Conversely, the state has very little downside. Other than internal time generated by the state's department of revenue or general counsel's office, typically minimal costs are incurred by the state.

Timing also works to the state's advantage, as states generally operate with the notion that they ''will get to it when they can.'' In other words, no need to hurry. If the state needs a statute extension, they ask, and if the taxpayer refuses to grant one, the state can issue a jeopardy assessment (again, with little or no basis). The deck is clearly stacked against the taxpayer and in favor of the state. It is not uncommon for audits to remain open for several years as issues transition from the audit level to the appeals level, not to mention the amount of time issues can sit at the court level before cases are heard or decided.

Corporate tax departments, however, are always being challenged with minimizing, not increasing, their audit inventory. FIN 48 implications, and the uncertainty surrounding the amount of liabilities needed on the books related to such assessments, also create financial statement pressure to alleviate these uncertainties as quickly as possible in lieu of maintaining significant liabilities on the books year after year.

Materiality thresholds offer yet another avenue for states to get away with issuing bogus assessments. States know that if the assessment is below a certain materiality level, chances are good that the company will just pay the assessment, or a portion thereof, to obtain resolution of the issue. The result, again, is additional money for the state. So, given all of the financial and accounting pressures with which taxpayers are faced, what reason would there be for a state not to issue an unreasonable or arbitrary assessment in hopes that something will come of it?

IT'S TIME TO PUSH BACK

Now that we have looked at the states' rationale to issue unreasonable and arbitrary assessments, let's further consider the ramifications of resolution strategies that only address the battle and not the war. First, the states know what they are doing. If a state learns through the issuance of one assessment that the taxpayer is willing to pay something just to get the state to go away, rest assured, the state will be back looking for more. Taxpayers definitely fuel the fire when they pay in cases where they shouldn't. Just like giving candy to assuage a petulant child often creates future unwanted behavior, the states that receive easy money from bogus assessments will be back holding their hands out for more. After all, if it worked the first time, why not try again?

With that in mind, taxpayers should think twice before simply paying up, even in cases that lack a strong

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or ''winnable'' position. Just as a state may be more interested in auditing for a second time a taxpayer that previously yielded cash, a state will be less interested in spending its field audit budget and time on a taxpayer who puts up a difficult fight.

Taxpayers should think twice before simply paying up, even in cases that lack a strong or "winnable" position.

Have you ever considered that a good fight in one audit could lead to a dismissal of a future audit? We had a situation where an auditor with whom we had previously battled actually walked away from a later audit of another company when he learned who was representing the taxpayer. Sure, this result may be the exception rather than the rule, but at least an expectation can be set that it will not be an easy fight if the auditor decides, or is forced, to perform the audit for a subsequent period. In the end, a state will be much less likely to invest money and time in a company it knows will fight vehemently as compared to a company it's sure will generate a return with little or no effort.

Logically speaking, why would a state evaluate its business risks and rewards any differently than your company evaluates its business risks and rewards?

Another often overlooked reason for putting up a fight is that the issue in future audit cycles may be worth much more than it is in the current cycle. It is often good strategy to fight hard when the dollars are small and not as material to the state and then use already prepared material and a prior decision to dismiss (or, at least, gain a one-step advantage on) the issue in years in which the dollars are more substantive. Yet, so many times the opposite occurs. A taxpayer will pay a portion of the assessment to the state when the dollars are small (putting themselves one step behind), and then find it difficult to remove or resolve the issue in later years which may contain larger dollar amounts.

For instance, one taxpayer paid six figures to settle an issue that rightfully should have been resolved in its favor. Not standing firm with its reported tax return position and lacking interest in battling with the state, the taxpayer simply settled the case. Should it have been a surprise to anyone when the state returned for the next audit cycle and issued a seven figure assessment? To the contrary, another taxpayer fought long and hard, incurring fees that actually exceeded the assessment for the first audit cycle. The result: A complete win for the taxpayer in the first cycle, followed by substantially easier wins in the subsequent cycles, at very little cost.

The more you concede unwarranted issues, the more difficult it is to get the state to expect something different from you.

Further to this point, the more often taxpayers pay in cases with unjustifiable assessments, the more states use that information against other taxpayers. How many times have you heard a state indicate that other taxpayers are paying 50 percent (or some other percentage) on this same issue, as if that is a reason for your company to pay on that same basis? Your response, if it's true, should indicate that this same issue has been won in other jurisdictions that have similar laws. Besides, that ''other taxpayer'' may have good tax or business reasons as to why it wanted the case resolved.

Let's face it, the more you concede unwarranted issues, the more difficult it is to get the state to expect something different from you. Clearly, it's time to quit allowing the states to run all over taxpayers; it's time to start pushing back! It's time to reset states' expectations and to swing the pendulum back to the side where taxpayers do not pay simply because they received an assessment.

CONCLUSION

While there are many instances in which good business reasons exist for a taxpayer to make a settlement payment in resolution of a state audit, the ''push back'' approach should not be overlooked in your effort to move from simply settling to *settling well*. Don't necessarily give in or settle up on audit assessments, particularly those that have little or no basis. Give consideration to what you might have to pay to that state when it returns for another cycle. Consider the expectations set when your company only seeks quick resolution and makes it easy for the state to receive revenue. Evaluate the intangible benefits of causing a state to think about whether it wants to spend the time and energy auditing your company in the future. While the battles are worth winning, the war is your ultimate goal. It's time to push back!

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