

STATE+LOCAL TAX INSIGHTS

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TOP TEN BEST AUDIT PRACTICES

By [Nicole L. Johnson](#) and [Rebecca M. Balinskas](#)

Benjamin Franklin famously said that nothing in this world is certain except death and taxes. And the certainty of taxes leads to the inevitability of audits. Whether you are preparing for your first State tax audit or your thousandth, keeping in mind the following ten best practices will help ensure that the audit goes as smoothly as possible.

NO. 1: IDENTIFY POTENTIAL ISSUES

The best offense is a good defense – true in both sports and tax. When you are preparing the tax returns, consider any issues that an auditor may focus on. Some items that might attract an auditor’s attention include instant unity for combined reporting states, characterization of income as business or nonbusiness income, sourcing of services for apportionment purposes and, unsurprisingly, any item that has a large tax effect. By preserving the necessary records to support your company’s filing positions in the beginning, you will decrease your work later.

Upcoming Speaking Engagements

December 5

Lexology and Morrison & Foerster Webinar

- “State Tax Impacts of U.S. Federal Tax Reform One Year On and Other Significant U.S. State Tax Developments”
Mitchell A. Newmark, William H. Gorrod,
Philip S. Olsen and Nicole L. Johnson

December 6

Bar Association of San Francisco Tax Section Meeting

San Francisco, California

- “State and Local Tax – 2018 Year in Review”
William H. Gorrod

December 17

New York University, 37th Institute on State and Local Taxation

New York, New York

- “Due Process – Significant Current Issues”
Craig B. Fields
- “Apportionment Issues: Recent Developments”
Holly L. Hyans

January 29 – 30, 2019

Ohio Tax Conference

Columbus, Ohio

- “State & Local Tax Basics: An Introduction to Multistate Taxation”
Mitchell A. Newmark
- “Tax Challenges of the Mobile Workforce: Payroll, Withholding, State Tax Nexus and Pending Federal Legislation”
Nicole L. Johnson
- “Nexus After *South Dakota v. Wayfair, Inc.*: Emerging Issues in State Tax Nexus – The Most Rapidly Changing Area of Taxation”
Craig B. Fields

NO. 2: KNOW THE STATE

When the auditor first contacts you, go through your records and review your past interactions with that State. Determine if the auditor or the audit supervisor has been involved in auditing your company in the past and, therefore, might already have an understanding of your company’s business and any recurring issues. Identify any issues that were challenged, traded or settled in prior audits with that State. Although each audit stands on its own, companies should expect some consistency among audits, assuming there has been no material changes in the company’s business or the relevant laws.

Also, familiarize yourself with the State’s procedures and deadlines. It is important to know any statutory deadlines you may be faced with. For example, in sales tax audits,

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South Dakota law provides that all information should be provided within 60 days from the start of the audit.¹

Make sure that your colleagues know what to do if an auditor contacts them.

NO. 3: PREPARE YOUR COMPANY

Make friends outside of your tax department. Audits often require information from different departments. For example, payroll information from the payroll department may be required for apportionment purposes in an income tax audit. If you already know Nancy in the payroll department, you have a go-to person to start the process of requesting the information. Further, Nancy is likely to be more responsive in timely giving you the information you need if you have a working relationship.

In addition, make sure that your colleagues know what to do if an auditor contacts them. Generally, there should be only one point person in your company who works directly with that auditor. This will make it easier for your company to keep track of the requests that are being made

by the auditor and the information that is being provided, which avoids unnecessary overlap and confusion.

NO. 4: SET THE GROUND RULES

Rules set a baseline for the audit. After you receive the audit notice, determine when the audit will start, ask for an audit plan and begin to work out a timeline for the audit. In doing so, consider the amount of time necessary to gather and review information requested by the auditor – keeping in mind any current demands on your company, such as other audits and return filing deadlines, and that interest will accrue on any audit adjustments. Prolonging an audit is rarely desirable, but may be necessary in certain circumstances. For example, taking the time to resolve some issues at the audit level may ultimately provide for a smoother, more efficient appeals process.

Additionally, let the auditor know if he or she will need to come to your company's offices to review information, or if your company is willing to send the auditor electronic copies of records. Remember that if your company sends the auditor electronic copies, it will be easier for the auditor to forward the information to others (including, potentially, other states).²

If the auditor will be coming to your company's offices, you should set a time each day to meet with the auditor to discuss the progress of the audit and any issues that may have arisen. This will help keep both you and the auditor on task and the audit moving on schedule.

NO. 5: EVERYTHING IN WRITING; COPIES OF EVERYTHING

Become a hoarder. Make sure that all requests and responses are in writing and retain copies – whether in paper or electronically. Also, keep an audit log that records when each request was made and when your company responded. This will help keep you organized during in-depth and/or lengthy audits and ensure that you have records of everything. Additionally, an audit log may be used to establish unreasonable delay by the taxing authority, which may reduce interest or penalties. Moreover, audit logs may be preserved and reviewed in future audits to ensure consistency in your company's responses.

NO. 6: HAVE A PLAN FOR RESPONDING TO COMMON ISSUES

Certain issues arise in nearly every audit and a prepared response provides consistency. For example, will your company agree to extend the statute of limitations to issue assessments? If the answer is no, or if your company has a limit on the number of extensions it will grant, let the auditor know in advance so that the auditors can plan their schedule accordingly. Granting an extension may be

helpful to prevent the auditor from issuing an estimated jeopardy assessment (which typically overestimates the amount of tax purported to be due). However, having a policy in place regarding the number of extensions can prevent the auditor from prolonging an audit indefinitely.

Make sure that all requests and responses are in writing and retain copies.

Also consider if your company is willing to provide information such as 50-State apportionment data or tax accrual workpapers. Although there is generally no requirement to provide such information, if the information supports your company's position, you may be willing to provide it to the auditor.

NO. 7: DON'T DISCLOSE PRIVILEGED OR CONFIDENTIAL INFORMATION

As the auditor requests information, it may be tempting to simply forward them all of the relevant information that you have. Keep in mind, however, that some information may be privileged (such as an email with in-house or outside counsel) or contain confidential or personal information (such as pricing terms in a contract or customer names or social security numbers).

Privileged information generally should not be disclosed. All states have an attorney-client privilege and some states have an accountant-client privilege.³ If you provide a document to an auditor that contains privileged information (such as an email with counsel discussing uncertain filing positions), the information may no longer be protected by the privilege and the auditor may be able to use that information in the audit.

Further, the auditor likely does not need to know confidential information or personal information about your company's employees or customers—and the auditor may not want such information. Confidential and personal information should be redacted unless the information is needed (for example, in a withholding audit, personal information may need to be disclosed). If information is redacted, you should let the auditor know and inform the auditor as to why the information was redacted.

NO. 8: KNOW THE TAX IMPACT OF POTENTIAL ISSUES

Knowing the tax impact of your company's issues will allow your company to make an informed decision on how it wants to proceed if the issues are challenged in an audit. In determining the tax impact of an issue, consider whether the issue affects only the current year or if the issue will continue to occur in future years. If it will be a reoccurring issue,

consider the value of the issue in future years and whether the impact of the issue will increase or decrease going forward.

If your company plans on engaging an outside advisor, identify and engage the advisor as early in the process as possible.

If you identify issues that your company will protest if challenged, consider to what level your company will appeal each issue and if your company will want to hire an outside advisor—such as an attorney or certified public accountant. If your company plans on engaging an outside advisor, identify and engage the advisor as early in the process as possible. For example, during the audit, the advisor may help frame the issues that will be appealed to set up a cleaner protest. Keep in mind that an advisor may work with you in the background or may deal directly with the auditor.

NO. 9: CLOSING AGREEMENTS: DON'T LEAVE ANYTHING OPEN

If your company decides to enter into a closing agreement to resolve the audit or certain issues raised during the audit, make sure that the agreement fully closes all of the issues that are covered by the agreement. For example, if a company in a separate reporting State enters into a closing agreement to resolve an addback issue, make sure that the closing agreement also precludes the taxing authority from assessing tax on any related entities on that same issue. This will prevent assessments potentially being issued to the related member.

NO. 10: PROTESTS: DON'T WAIVE ANYTHING

When protesting audit adjustments, confirm the procedures and deadlines of the State. Keep in mind that states may change their statutory deadlines and that the deadlines indicated in notices from the taxing authority

may be wrong. For example, last year Pennsylvania reduced the statutory deadline to protest an assessment from 90 days to 60 days, but the Department of Revenue continued to issue notices indicating that taxpayers had 90 days to appeal.⁴ An untimely protest may preclude any relief.

Also, if your company is expecting an appealable notice, follow up with the auditor periodically to ensure that you have not missed the notice. Recently, the New Jersey Tax Court found that a company's protest of an assessment was untimely where the company only discovered (and protested) an assessment after the Division of Taxation commenced collection activities.⁵ The Division had addressed the assessment to an entity that was no longer in existence and the company's mailroom forwarded the notice to the wrong entity.⁶ Checking in with the auditor will ensure that you are aware when the notice has been issued and allow your company to protest in a timely manner.

If your company is expecting an appealable notice, follow up with the auditor periodically to ensure that you have not missed the notice.

Further, make sure that all issues are raised in a timely manner. In some states, companies must raise all issues in the initial protest and may be precluded from raising any new issues later. You don't want any issues to go unchallenged simply because of procedural reasons.

CONCLUSION

Audits are daunting—particularly when they are extremely in-depth or prolonged. Following these ten best practices will help ensure that an audit runs smoothly and that any adjustments are either properly closed or appealed.

1 See S.D. Codified Laws § 10-59-7 (providing that, generally, any record that is not presented to the auditor within 60 days from the commencement of the audit does not have to be considered by the auditor).

2 States may share companies' tax information pursuant to tax sharing agreements. See, e.g., N.C. Gen. Stat. § 105-259(b)(3); N.J. Rev. Stat. § 54:50-9(f); N.Y. Tax Law § 202.3.

3 For example, California and Florida have accountant-client privileges. See Cal. Rev. & Tax. Code § 7099.1; Fla. Stat. § 90.5055. New York does not. See *First Interstate Credit*

Alliance, Inc. v. Arthur Andersen & Co., 150 A.D.2d 291 (N.Y. App. Div. 1989) (noting that New York does not have an accountant-client privilege).

4 See 72 Pa. Stat. Ann. § 9702(a).

5 *Merrill Lynch Credit Corp. v. Dir., Div. of Taxation*, No. 004230-2017 (N.J. Tax Ct. Sept. 28, 2018), *corrected opinion*, (Oct. 2, 2018).

6 *Id.*

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. If you wish to change an address, add a subscriber, or comment on this newsletter, please write to Rebecca M. Balinskas at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email her at rbalinskas@mofo.com, or write to Matthew F. Cammarata at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email him at mcammarata@mofo.com.

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STATE + LOCAL TAX

WHAT SEPARATES US FROM THE REST?

OUR EXPERIENCE. We've been doing it longer, have more experience and published decisions, and have obtained a greater number of favorable settlements for our clients than the rest.

OUR TRACK RECORD OF PROVEN SUCCESS. We've successfully litigated matters in nearly every state, and have resolved the vast majority of matters without the necessity of trial.

OUR NATIONAL PERSPECTIVE. We approach state and local tax issues from a nationwide perspective, taking into account the similarities and differences of SALT systems throughout the United States.

OUR DEPTH. Our team is comprised of a unique blend of public and private backgrounds with experience spanning various industries. We're nationally recognized as a leading practice for tax law and tax controversy by *Chambers*, *Legal 500* and *Law360*. In fact, we've been referred to as "one of the best national firms in the area of state income taxation" by *Legal 500 US* and were rated Law Firm of the Year for Litigation – Tax by the 2016 "Best Law Firms" Edition of *U.S. News & World Report – Best Lawyers*.

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