Sales Tax Corner

Nuances of State Sales Tax Voluntary Disclosure Programs

ILYA A. LIPIN is a Managing Director and Atlantic Region State and Local Tax Practice Leader at BDO USA, LLP, and an Adjunct Tax Professor at Villanova University Charles Widger School of Law Graduate Tax Program. **MADISON WALLEY** is an Experienced Senior State and Local Tax Associate and **ALEXIS TURNER GARRIS** is an Experienced State and Local Tax Associate at BDO USA, LLP.

By Ilya A. Lipin, Madison Walley, and Alexis Turner Garris

Wolters Kluwer®

Where Does Sales Tax Exposure Come from?

Three years after the U.S. Supreme Court issued its seminal decision in the *Wayfair* case, 45 states have enacted economic nexus rules and require remote sellers to register and remit sales tax if their activity exceeds a certain threshold (*i.e.*, volume of sales (*e.g.*, $100,000) and/or transactions (*e.g.*, 200)), generally measured within the past or current year. The intent behind the economic nexus threshold rules is to establish a bright-line test for determining whether a company's activities based on sales and/or volume of transactions is sufficient to establish nexus with a jurisdiction, level the playing field between the instate and out-of-state retailers, ensure a state's ability to collect tax on taxable transactions, attempt to simplify compliance, and provide a safe harbor for smaller businesses with limited retail sales. However, in reality, *Wayfair* laws increased the sales tax compliance burden and heightened the anxiety for many multi-state taxpayers.

The rush by states and certain local jurisdictions in home rule states to adopt *Wayfair*-like standards, community outreach by the departments of revenue, and industry-focused discussions of potential enforcement trends increased taxpayer awareness about the sales tax nexus issues, but it did not lead to high-level compliance. Some recent surveys mention that less than 50% of taxpayers are compliant with the *Wayfair* laws.[1] It is estimated that only a fraction of the 2.1 million online retailers in the United States are collecting and remitting sales tax to states in which an obligation exists.[2]

There are several reasons for noncompliance. Many companies have limited or no dedicated resources to the time-consuming and complex sales tax function that needs to be attended to at least on a monthly basis. A generalist without sales tax knowledge may not fully comprehend the nuances of the economic nexus thresholds (*e.g.*, whether to measure thresholds based on taxable versus gross sales, whether to include marketplace sales, and which period to use), be able to timely track the lowering of thresholds levels (*e.g.*, Tennessee), make accurate taxability and rate determinations, and consistently comply with all sales tax obligations.

© 2021 CCH INCORPORATED AND ITS AFFILIATES. ALL RIGHTS RESERVED.

Misunderstanding the applicable rules could have unintended consequences. For instance, some companies that sell through a marketplace incorrectly believe that, in all states, marketplace facilitators have been required to collect on their behalf. In about 27 states, marketplace facilitator laws have later effective dates than economic nexus laws, thus creating a potential compliance gap, where the retailer, and not the facilitator, is responsible for sales tax collection and remittance.

Even with a dedicated sales tax employee, turnover, retirements, COVID-related layoffs and furloughs may lead to sales tax knowledge leaving the company's doors. Without an immediate transition in place, returns may go unfiled for months.

In discussions about *Wayfair*, many companies, including inbound companies seeking to expand their operations in the United States, realize that their physical nexus footprint is substantially broader than previously envisioned. Businesses are discovering that they have established economic nexus in U.S. states over the last few years and failed to collect sales tax on their products and services. Additionally, some of these companies had created physical nexus before the *Wayfair* decision by having employees or independent agents working on their behalf in the United States, soliciting in-person sales across state lines, participating in tradeshows, and/or maintaining inventory in warehouses or through fulfilment programs (*e.g.*, Fulfilment by Amazon).

The fear of the unknown often prevails over proactive problem-solving and a wait-and-see approach is adopted. Without a triggering event, such as an audit, financial statement release, or due diligence related to a transaction, a company may choose to delay taking action to resolve noncompliance until it is absolutely necessary.

Some businesses realize that they cannot absorb the costs associated with hiring a professional to assist with sales tax, outsourcing, or automating their sales tax function. These businesses choose to do as much as they can in the hope that they will not be selected for audit in a jurisdiction where they are less compliant.

Whatever the reason for noncompliance, failing to comply with sales tax collection and filing obligations can lead to devastating sales tax exposures, including the imposition of interest and penalties. Considering the audit cycles driven by the general three-year statute of limitations for assessment (for filers), given the recent *Wayfair* three-year anniversary, many taxpayers are likely now beginning to deal with audits that test their compliance with economic nexus laws.

One path for companies with exposure due to noncompliance may be to consider a voluntary disclosure agreement (VDA) with the state before getting back on track and registering for prospective collection of sales tax. While VDA programs have similar general characteristics, many are unique. Prior to proceeding with a VDA, one should consider the detailed rules of each state's VDA program to ensure qualification and choose an experienced professional to guide through some of the nuanced situations exemplified in this article.

Benefits of a VDA

A VDA is a contractual agreement between the company and the taxing jurisdiction where, in exchange for voluntarily coming forward to settle prior tax liabilities, the taxing jurisdiction will make certain concessions. VDAs are designed to promote voluntary compliance and encourage taxpayers to address overdue tax liabilities, thus allowing the state to collect some tax that was due.

One of these concessions is providing a reduced filing period, or look-back period, of generally three to four years. Some states (*e.g.*, Hawaii and Nevada) have longer look-back periods; Hawaii provides a look-back period of 10 years but may look beyond that in certain situations,[3] and Nevada provides a look-back period of eight years. The look-back period varies among the states, but it can also vary within a state based on the taxpayer or type of tax. For example, Pennsylvania's look-back period is three years plus the current year for non-corporate tax liabilities, such as sales tax, versus five years plus the current year for corporate tax liabilities.

Another concession granted under a VDA is a reduction or abatement of late filing and late payment penalties. Typically, states will reduce or abate penalties for the periods within the look-back period and forgive any prior period liabilities outside the look-back period. In some instances, interest is also reduced or abated but this is not as common. Texas usually grants taxpayers relief from interest, but has a four-year look-back, and a few other states will reduce interest on a case-by-case basis.

In addition to the above concessions, most states will allow taxpayers to apply for a VDA on an anonymous basis so that they feel more comfortable coming forward. The taxpayer's identity will eventually be revealed, but this typically occurs after the agreement is in place. A few states, such as California, Illinois, New York, and Nevada, do not offer anonymity at any stage in the process and require the company's identity to be disclosed during the initial VDA proposal.

An additional and equally important benefit is the company becoming compliant with the state. Noncompliance can impact a company's ability to do business in a state and it can also interrupt negotiations for the sale of the company to an acquiring company since sales tax compliance is an area of focus during the due diligence phase.

Application Considerations

Many states have formal procedures for VDAs. In states that allow a company to apply on an anonymous basis, the procedures must be followed carefully so that the company does not disclose any identifying information before an agreement is in place that could potentially jeopardize the VDA.

VDAs are deadline and form-driven. Generally, the company will need to provide the following information as part of the disclosure:

- Background of the company, including the state of incorporation, principal business activity, and description of its products;
- The date on which nexus first arose;
- Information about how nexus was created, including whether the company owned or leased tangible or real property or maintained inventory in the destination state, the number of resident employees, the scope of solicitation and post-sale activities, or whether the company had independent contractors/agents who provided technical assistance or services in the destination state;
- Volume of sales into the state and estimated historical sales tax liability;
- Whether the company collected but did not remit sales tax from its customers; and
- Whether the company is qualified to do business with the state, is registered with the secretary of state, or is registered with the Department of Revenue (DOR) for any other taxes.

Many states use this disclosure as an exhibit to the VDA. If the state is satisfied with the information provided, it will present an agreement to the company with the terms and conditions to which the company must agree before proceeding to the next step. Once the agreement is in place, the company's identity is revealed (if previously anonymous) and the company must send the tax returns and any supporting documentation to the state. The state may accept a workpaper that details the calculation of the tax liability *in lieu* of tax returns but the company should first confirm with the state and consider having it as a contractual provision.

Disclosure Without Agreement

It is important that the information provided in the initial disclosure and throughout the VDA process is accurate and complete. As part of the VDA, states reserve the right to examine the company's records and verify the amount of the tax liability and the accuracy of the company's representations. For instance, if the company claims that it is exempt from sales tax because some of its sales are for resale purposes, it may be required to show a valid exemption certificate associated with such transaction. A VDA may be voided if relevant information is omitted from the disclosure or if the exposures are improperly quantified. In this case, the state may assess any tax determined to be due that was not discharged under the VDA and impose all applicable penalties and interest on additional taxes discovered to be due that have not been paid.

Liability paid outside of a VDA may not offer the same benefits, even if the taxpayer subsequently applies to participate in the program. For example, in *the Matter of Morris A. Hazan Family Foundation*, an exempt entity disclosed and paid tax outside of a VDA program and was not afforded the limited look-back period prescribed in the states' VDA program.[4] In that case, the taxpayer worked with the DOR through a mediation service to resolve the disputed tax due during the period 2007–2014. After settling the matter, the taxpayer subsequently appealed asserting that it would have been eligible for the VDA program and, had it been advised to apply for the program, it would have had to pay tax and interest for as little as three years, instead of the eight years of tax and interest that it paid.

In New York, to apply for the VDA program, a taxpayer must submit an application through a process established by the Commissioner. The New York Division of Tax Appeals denied a taxpayer's petition for refund under the VDA program because the taxpayer submitted past due returns and a cover letter requesting penalty abatement to the Division of Taxation but not a VDA program application. The Division of Tax Appeals found that because the taxpayer had not followed the procedure and did not submit the required documents to apply for the program, it was not eligible for the program or its limited look-back period.[5]

Disqualification

In most states, a company is disqualified from the VDA program if it was previously contacted by the DOR regarding matters relating to voluntary disclosure, the taxpayer is already registered for the type of tax involved in the disclosure, or if the tax was collected. In some states, receiving a nexus questionnaire from the DOR for one company in a group may disqualify the entire group from pursuing a VDA.

Wolters Kluwer®

 © 2021 CCH INCORPORATED AND ITS AFFILIATES. ALL RIGHTS RESERVED.

For example, in its Review Determination No. 18-0070, the Washington State Administrative Review and Hearings Division found a taxpayer had not met the requirements to participate in the VDA program because a registered affiliate had contact with the DOR.[6] The dispute arose following a DOR decision to apply the "no contact" rule to a taxpayer though the entity specifically had not had any contact with the DOR; instead, an affiliate had been audited by the DOR a few years prior. The DOR found such contact sufficient to deny the taxpayer's VDA application and the Review Board agreed. The rule applied even where, as in this case, the entities were treated separately for tax purposes.[7]

While it may seem impossible to overcome the broad application of the VDA "no contact" rule, in *Waupaca Foundry, Inc. v. Michigan Department of Treasury*, the Tax Tribunal found a company had not become disqualified from participation in a VDA program due to a tax auditor's inquiry and subsequent fact-finding calls.[8] In that case, the Tax Tribunal noted that the auditor could not recall during his deposition the substance of his conversations with the company. Without more, the court found that the internal memo reflecting calls and facts obtained about the company was not enough, per the plain meaning of the statute, to disqualify the company on the grounds that it had contact with the tax department.[9]

These examples illustrate that the state contact history of taxpayers and their affiliates must be thoroughly examined to assess whether the contact rises to a level that would lead to disqualification prior to pursuing a VDA. The type of contact that leads to disqualification varies by state and requires an analysis of the rules specific to each state's VDA program. Facts similar to *Waupaca* applied to a VDA in another state may lead to disqualification.

Registrations

Several states require companies to consider and include other taxes in the VDA. For instance, Pennsylvania may ask the company to complete income tax returns for the past five years, including returns of nonresident individuals. In Ohio, Texas, and Washington state, sufficient sales into the state may also have nexus implications for gross receipts-based taxes. If the company neglects to include all taxes in a VDA with a state that has such a requirement, the state may audit, assess, and demand payment for those taxes, even for years before the look-back period. Engaging a firm that only specializes in sales tax and cannot address other state tax compliance obligations (present or future), such as income tax or gross receipts tax, may prevent the company from successfully completing the VDA and staying compliant moving forward.

An inbound entity looking to complete a VDA should be aware of certain undisclosed registration rules that may complicate the process. Even if the activities of an inbound company may not rise to the level of a permanent establishment, it may establish nexus for state and local tax purposes. For instance, inbound companies without a Federal Employer Identification Number (FEIN) will generally not be allowed to register with the DOR as part of completing the VDA program. Some will issue a temporary number, which after the completion of the VDA cannot be used for compliance purposes. Subsequent registration will be required if the foreign company continues to have nexus and make taxable sales in the state post-VDA. Ongoing compliance is tracked by the VDA auditors, and any failure to abide by the terms of the agreement may result in further investigation or audit.

Limitations on Amending Returns

Most states do not allow companies to amend their returns or request refunds for tax periods that fall within the VDA look-back period. Thus, if an inaccurate amount of tax or credits is reported on the return, or through further research the company determines that it did not have nexus with the state, or if its product is exempt from tax, or if a customer belatedly issues an exemption certificate or presents proof that it paid tax either as a self-assessment or upon audit, the company cannot thereafter recover the amounts paid under the VDA. However, some states, on a case-by-case basis, may allow taxpayers to amend returns while the VDA is still open and payment has not been made.

Extensions

Even if the procedures are followed, the windows to research the rules and provide customer exemption documentation and registration, and to file tax returns may be as short as 30 days. Missing a deadline may lead to cancellation of the VDA, which can have serious consequences since the state will then know the identity of the taxpayer. Knowing who and when to request an extension can save the VDA. The best practice is to request an extension of time as soon as practicable, well in advance of the deadline. Last minute requests are typically not received well and have a higher probability of being denied.

Wolters Kluwer

VDAs in Local Jurisdictions

Companies should consider whether they have any exposure due to local jurisdictions that impose sales tax. Non-state-administered localities will not be covered under a VDA with the state, and the locality will likely need to be contacted directly to determine whether a VDA or similar option is available. Exposure in a home rule state, such as Colorado or Louisiana, which grant their local governments the authority to establish and administer taxes, may cause a company to file numerous VDAs to become compliant in one state.[10] Even if the company has already been under audit or otherwise contacted by one local jurisdiction in the state (for instance, Colorado Springs, Colorado), it may still be eligible to enter into a VDA with another local jurisdiction (Denver, Colorado).

Lessons and Recommendations

Sales tax compliance is more challenging now than ever before due to economic nexus laws enacted in all states that impose sales tax, as well at the local level (*e.g.*, Alaska). With these economic nexus laws in place, and three years post the *Wayfair* decision, states are becoming aggressive in their pursuit of noncompliant companies. Many states are purchasing lists of sellers to compare with their lists of registrants to identify companies that should be collecting and remitting sales tax. Arizona has taken the additional step of enlisting the help of a data analytics company.[11] Noncompliant companies should act promptly to get ahead of these efforts and seek VDAs because they will benefit from a limited look-back period and abated or reduced penalties and interest.

In seeking a VDA, it is paramount to follow the procedures and rules of the VDA and to provide the state with complete and accurate information. Otherwise, companies risk disqualification from the VDA or voiding the VDA, which can happen even after the agreement is in place. Disclosure before the agreement is in place can also jeopardize the VDA. Engaging a firm with extensive VDA experience can help taxpayers navigate these important considerations and avoid pitfalls. Having long-term relationships and experience in working with state and local tax administrators on a regular basis, knowing the amount of detail to include in the applications and how the process works, being able to comply with additional tax obligations, and managing the process within strict deadlines is critical to ensure the successful completion of a VDA.

Wolters Kluwer

ENDNOTES

1 Liz Armbruester, *How Accountants View the Impact of Wayfair Three Years Later*, BNA, Jul. 28, 2021 ("A December 2020 survey found that 42% of small businesses considered themselves to be completely compliant with Wayfair laws.")

2 Michael J. Bologna and Tripp Baltz, *Billions Lost as Thousands of Sellers Flout State Sales Tax Laws*, BNA, June 22, 2021.

3 Hawaii will agree to a 36-month VDA for excise tax if the taxpayer participates in the MTC's National Nexus Program.

4 *In the Matter of Morris A. Hazan Family Foundation*, N.Y. Div. of Tax Appeals, Det. No. 828843, Dec. 10, 2020.

5 *In the Matter of Morris A. Hazan Family Foundation*, N.Y. Div. of Tax Appeals, Det. No. 828843, Dec. 10, 2020.

6 Wash. Dep't of Rev., Tax Dec. Det. No. 18-0070, 39 WTD 001, Mar. 25, 2020.

7 Wash. Dep't of Rev., Tax Dec. Det. No. 18-0070, 39 WTD 001, Mar. 25, 2020.

8 Mich. Tax Tribunal, No. 266585, July 3, 2001.

9 Mich. Tax Tribunal, No. 266585, July 3, 2001.

10 Louisiana now has a process to enter into a single VDA covering multiple parishes.

11 Michael J. Bologna and Tripp Baltz, *Billions Lost as Thousands of Sellers Flout State Sales Tax Laws*, BLOOMBERG DAILY TAX REPORT, June 22, 2021.

This article is reprinted with the publisher's permission from JOURNAL OF STATE TAXATION, a quarterly journal published by CCH Incorporated. Copying or distribution without the publisher's permission is prohibited. To subscribe to JOURNAL OF STATE TAXATION or other journals, please call 1-800-344-3734 or visit taxna.wolterskluwer.com. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.

 © 2021 CCH INCORPORATED AND ITS AFFILIATES. ALL RIGHTS RESERVED.