Through the Mists of State Tax Administration

ABA State and Local Tax Committee
Boca Raton, FL
January 31, 2020

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In Quest of a Level State Tax Playing Field

• All taxpayers want to believe that they are being subjected to the same state tax compliance and enforcement obligations as similarly situated taxpayers (particularly their competitors) are being treated to.

• In the same vein, state and local tax agencies need to provide comfort that all taxpayers are being treated equally.

• A taxpayer that is being subjected to discriminatory tax treatment may have a constitutional claim under the Due Process Clause, Equal Protection Clause or Uniformity Clause.
In Quest of a Level State Tax Playing Field

• This where the proper balance needs to be found between:
  • The statutory confidentiality obligations that state tax agencies labor under to
    preserve the confidentiality of the tax return and audit information of specific
    taxpayers.
  • The objective of providing transparency in the administration and
    enforcement of state tax laws.

• As much as tax agencies may want to provide transparency, they
  cannot violate actual legal confidentiality obligations of the agency
  and its employees.
In Quest of a Level State Tax Playing Field

• Taxpayers may find it difficult to develop the facts needed to support a constitutional claim of discriminatory state tax treatment?
  • It’s very unlikely the state tax agency would allow the taxpayer to review tax returns or audit files of other taxpayers.
  • The taxpayer could serve discovery requests on the state tax agency if the matter is on administrative appeal or before a court reviewing an assessment.
    • Will the administrative tribunal hear the constitutional claim?
    • Will the state tax agency provide substantive responses to interrogatories or requests for admission asking the agency to explain how other taxpayers have been treated by the agency on a particular state tax issue?
    • Will the state tax agency object to the discovery requests on the grounds that they would require the agency to disclose confidential taxpayer information?
    • Can the state tax agency provide discovery responses in redacted form to resolve confidentiality obligations?
In Quest of a Level State Tax Playing Field

• Can the taxpayer request the state tax agency to produce ruling letters (in redacted form) provided to other taxpayers on the state tax issue?
• The taxpayer could try to take the deposition of the auditor or an official within the state tax agency to elicit this information.
  • This line of questioning may run into the same objections from the state tax agency.
• At the end of the day, trade associations and other businesses may be the most fertile source of information about how other taxpayers are reporting a particular state tax issue on their returns and how that issue is being resolved in audits.
  • Nothing like a jealous competitor!
Friday, September 4, 1925

Names of Wealthy on Non-Taxable List

Several Well Known New Yorkers Make No Payment on Their 1924 Income

Among those so listed are Lewis Nixon, shipbuilder and former Public Service Commissioner; Edgar F. Luckenbach, steamship man; Marc Klaw, theatrical manager; Henry L. Doherty, banker, and Samuel Untermyer, lawyer. It was suggested that this probably was due to investments in tax-exempt securities.
Brief History of Income Tax Disclosure

- 1913  Sixteenth Amendment is ratified.
- 1917  Congress requires the Commissioner to make available for public inspection lists containing the names and addresses of individuals who filed a tax return.
  The law is soon amended to grant 1% shareholders the right to view tax returns of the corporations whose stock they own.
- 1924  Congress amends the law to add the amount of tax paid to the public lists. Disclosure applies to both individuals and corporations.
- 1925  U.S. Supreme Court upholds the right of newspapers to publish these lists in *U.S. v. Dickey*, 268 U.S. 378.
Brief History of Disclosure (continued)

• 1926 Congress repeals the requirement to include the amount of tax paid on the public lists, due in part to the opposition of the Secretary of the Treasury and to business lobbying.

• 1934 Congress requires both individual and corporate taxpayers to file a “pink slip” with their tax return, containing gross income, total deductions, net income and tax liability, and requires the slips to be available for public inspection for three years.

• 1935 Spirited debated erupts between the proponents and opponents of the pink slip law.

• 1935 Congress repeals the pink slip law in April before the disclosure provision becomes operative.
Recent Illinois experience

Tax confidentiality provisions in State tax code:
“All information received by the Department from returns filed under this Act, or from any investigation conducted under this Act, shall be confidential . . . .”

2016: The Illinois General Assembly amends the state’s FOIA:
“All settlement . . . agreements entered into by or on behalf of a public body are public records subject to inspection and copying by the public, provided that information exempt from disclosure under Section 7 [Exemptions] of this Act may be redacted.”
State tax settlement agreements

Section 7(1)(a) of the FOIA. “Exemptions . . . Information specifically prohibited from disclosure by federal or State law or rules and regulations implementing federal or State law. . . .”

Probably confidential.

City of Chicago tax settlement agreements

Section 3-4-080 (A)(1) of the Uniform Revenue Procedures Ordinance. “All information that the department . . . receives from returns or reports from any investigation, or from any hearing conducted under this chapter, or under any tax ordinance, shall be confidential and shall be used for official purposes only.”

Probably not confidential.
High stakes: Illinois DOR General Counsel held in contempt of court

- Taxpayer protested an assessment which was based on its use of the single transportation factor rather than the three-factor formula.
- The trial court subsequently held the Department’s General Counsel in contempt when the Department refused to comply with a discovery order requiring in camera disclosure of which businesses on a list provided by the taxpayer had used the transportation formula and which had been audited.
- The General Counsel asserted that the confidentiality provision of the Income Tax Act prohibited the Department from releasing the information.
- The Illinois Appellate Court reversed the order, holding that the Income Tax Act did not create an exception for disclosure pursuant to a court order.
High stakes: Illinois DOR General Counsel held in contempt of court

• The Appellate Court also held that the requested information was not discoverable because it was irrelevant: “Whether other companies unrelated to [the taxpayer] calculated their income taxes as transportation companies, and whether they were audited for doing so, is irrelevant to the issue of whether [the taxpayer] should be designated a transportation company for income tax purposes.”

• Taxpayer had not alleged disparate treatment or a violation of due process or equal protection. Query whether that would have produced a different result?

TTX v. Whitley et al., 692 N.E.2d 790 (Ill. App. 1st Dist. 1998)
Kentucky experience

Mark Sommer, Esq. sought copies of final rulings issued by the Kentucky Department of Revenue in response to protests of tax assessments (with taxpayer names redacted).

Rulings contain a statement of the issues in controversy and the Department’s position on each issue.

The Department refused to disclose the rulings, citing taxpayer confidentiality.

Sommer sued under the state’s Open Records Act, the Department eventually released rulings but only in cases where the dispute had been appealed to the Board of Tax Appeals, and Sommer appealed.
Kentucky experience

*Finance & Administration Cabinet, the Kentucky Dept. of Revenue, v. Sommer, No. 2015-CA-001128-MR (Ky. Ct. App. 1/13/17)*

The Department invoked the Kentucky Taxpayer Bill of Rights which

(1) guarantees that taxpayers “shall have the right to privacy with regard to the information provided on their Kentucky tax returns and reports,”

(2) prohibits the disclosure of any “information pertaining to the returns, reports, or the affairs of a person’s business,” and

(3) prohibits DOR employees from disclosing “any information produced by a hearing or investigation, insofar as the information may have to do with the affairs of the person’s business.”
Kentucky experience

The Kentucky Court of Appeals, in a 2-1 decision, required disclosure of the rulings, finding that the requested information provided guidance to taxpayers and did not include any taxpayer specific information.

The dissent asserted that the Taxpayer Bill of Rights prohibited disclosure of the rulings, and that the majority was relying on a policy argument.

The Department appealed to the state Supreme Court. The Supreme Court split 3-3, with the Justice who had dissented below—and was subsequently elected to the Supreme Court—recusing himself. As a result, the Court of Appeals decision was affirmed.
Kentucky experience

The following Spring, a conference committee of the Kentucky General Assembly—without providing any advance notice--inserted a provision into a tax package reversing the *Sommer* decision. The legislation was signed by the Governor.

The new law prohibited DOR employees from disclosing unappealed final rulings, requests for guidance, private letter rulings, and alternative apportionment requests and responses.

Just two weeks later, on the last day of the Spring 2019 legislative session, the General Assembly passed another bill, this one repealing the new anti-disclosure law. The Governor signed this bill.
Kentucky experience

State Tax Notes, October 15, 2019, after reviewing the released rulings:

“Many of the rulings upheld either an assessment or a refund denial because taxpayers failed to provide documentation or supporting statements stating the grounds upon which the protest was made. The rulings cite KRS 131.110(1) and two Kentucky Court of Appeals cases: *Eagle Machine Co. Inc. v. Commonwealth ex rel. Gillis* from 1985 and *Scotty’s Construction Co. v. Revenue Cabinet* from 1989.”
Tax Analysts – Our Efforts for a More Transparent System

• 1972 suit to gain access to IRS private letter rulings and technical memorandum.
• Nearly 50 years of litigation in defense of disclosure and tax transparency.
• The fight for transparency at the state level will be different than it was at the federal level.
  – 50+ unique taxing systems
Our Purpose:

• Provide a service to the tax community by helping minimize the misunderstanding between taxpayers and states.

• Place information into the hands of taxpayers, in hopes of all parties being on the same page.

• More information in the hands of taxpayer makes for a better functioning tax system.
• Accountability – there is a level of accountability here to make sure the states are training their auditors effectively, keeping abreast of the laws, and making an effort to stay current.
Audit Manuals Project

- Tax Analysts requests field audit manuals from Departments of Revenue.
- Rough Break Down: 20 publicly available, 20 we were able to make publicly available or given to us, 10 we have not been able to obtain.
- We try to negotiate with the state to make sure our request is not overly burdensome.
Audit Manuals

States argue the manuals:

• Are confidential investigative techniques that can't be disclosed.
• Contain confidential taxpayer information.
• Too burdensome to go through, identify, and redact confidential info.
Audit Manuals

Reasons of Refusal:

• Some states have citizenship requirement to obtain records act (example Utah statute).

• Some states have statute forbidding public release of tax audit manuals (example Utah - information classified as protected under Utah’s Government Records Access and Management Act ).
Audit Manuals – Challenges With Illinois

• Illinois was the largest state that had not provided manuals.
• Tax Analysts submitted a FOIA request in February 2017.
• In March 2017 DOR denied arguing the audit manual “contains opinions and discussions that guide the enforcement of tax law.”
• Tax Analysts narrowed its request in April 2018 to the audit manuals currently in use.
• Department again denied the request, arguing the request would be unduly burdensome.
Audit Manuals – Illinois cont’d

- Circuit Ct rejected DOR’s claim because Tax Analysts had not sought “all records falling within a category” but rather only a single record.
- December 2018, Tax Analysts filed suit against the DOR arguing DOR improperly withheld public records despite clear authority the manual should be released.
- Circuit Court ruled December 18, 2019 in favor of Tax Analysts, finding the DOR failed to show that producing the audit manual would be unduly burdensome.
- DOR is required to provide the manual within 30 days.
Matter of Moody’s Corp. & Subsidiaries

- Moody’s -- Audit involved a receipts sourcing issue settled in 2012 with closing agreement.
- New York Audit Division required Moody’s to source its credit rating receipts on an origination basis.
- Division told Moody’s it never allows credit rating service providers to source their receipts on a destination basis.
Moody’s (cont’d)

• Moody’s entered into a closing agreement believing all providers must source their credit rating receipts on an origination basis.

• Moody’s learns the Tax Department permitted its competitor to source on a destination basis.

• The Department allowed a similarly-situated taxpayer to source its credit rating receipts under a different method Moody’s sought a refund

• Moody’s sought release of documents through a FOIL request.
Moody’s (cont’d)

The case will bring attention to few important concepts regarding disclosure:

• the deliberative process exemption
• the public interest privilege
Deliberative Process Exemption

- Under New York’s FOIL (as with federal FOIA) there’s a presumption of access unless records or portions fall within specific exemptions.
- Deliberative Process Exemption is designed to protect suggestions and recommendations made while developing policy.
Deliberative Process Exemption (cont’d)

• Question is - Are requested documents part of the process of developing policy?

• Seems no -- Division informed Moody’s of its existing policy on sourcing of credit rating receipts: Destination sourcing is not permitted for credit rating receipts.

• Therefore, these documents between agency personnel should be the application of a set of standards to Moody’s fact pattern.
Moody’s (cont’d)

Deliberative Process Exemption (cont’d)

- Cannot develop a body of “secret law.”
- Tax agencies are not permitted to use the deliberative process exemption as a “veil of privilege” to shield all communications from public disclosure.
- That appears to be what has happened in New York.
Public Interest Privilege

- Prevents the disclosure of documents or information if disclosure is against the public interest.
- Harm outweighs disclosure of the information.
- In *Moody’s*, the ALJ allows the broad concept that the public interest is served by protecting the Division’s internal deliberative processes.
Taxpayer Privacy

• Confidentiality of taxpayer information is not an issue in Moody’s.

• Moody’s tailored its document requests to exclude any information that included confidential taxpayer information or information protected by attorney-client privilege.
Moody’s (cont’d)

Potential Problems:

• Was equal weight afforded to Moody’s challenge of the Closing Agreement due to disparate treatment of similarly-situated taxpayers?

• Does the Department’s contrasting treatment of similarly-situated taxpayers cut against the public’s interest in encouraging openness from the Department and maintaining integrity and finality of negotiated settlement agreements?
Moody’s (cont’d)

Holding
New York Division of Tax Appeals determined on October 24, 2019, that Moody’s should have been allowed to source a subsidiary’s credit rating receipts on a destination basis for corporate franchise tax purposes. The company was therefore entitled to a discretionary adjustment for the years in question.
Benefits of Transparency

• For taxpayers
  – Certainty
  – Improves taxpayer ability to voluntarily (and accurately) comply with tax laws

• For states
  – A transparent tax system
    • improves a revenue department’s efficiency in administering the tax system
    • increases taxpayer and tax practitioner certainty, and
    • reduces the likelihood that questions will turn into full-fledged controversies
War Story Time!

• What are your experiences with the tension between transparency and confidentiality in state tax matters?