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Subject: Nonfiling Exposure - Voluntary Disclosure
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To Our Clients and Friends:

In light of budgetary shortfalls, state and local taxing jurisdictions have become more aggressive with audit activities. This increased aggressiveness has manifested itself most readily in forced combination attempts, Section 482-type audits, attribution of expenses to nontaxable income, and the targeting of nonfilers. With regard to the latter, advanced audit techniques, computer cross-matching, and multi-jurisdictional information sharing have produced an environment in which state and local taxing authorities are increasingly able to recapture lost revenue from nonfilers. Thus, taxpayers with nonfiling exposure are at greater risk of detection than ever before.

A nonfiling assessment, in addition to being unexpected, can be quite onerous. The assessment may be based on data obtained from the taxpayer, or may be estimated by the taxing jurisdiction. The assessment will generally cover the period of time commencing with the date the taxpayer started doing business in the jurisdiction. For example, an entity that began conducting activities in a jurisdiction in 1975 could owe taxes to that jurisdiction from 1975 forward, or 30 years. No statute of limitations is generally available to limit the years, and penalties and interest often exceed the tax liability.

Taxpayers are often unaware of a nonfiling exposure. This is not surprising since there is no bright line test to determine if a taxpayer's activities result in nexus from one jurisdiction to the next (despite the fact that the United States Supreme Court addressed standards for income and sales/use tax nexus in Wisconsin Department of Revenue v. William Wrigley, Jr., Co. (June 19, 1992) and Quill Corp. v. North Dakota (May 26, 1992), respectively). Because there is no bright line test for nexus, contested areas are many, including Public Law 86-272 and de minimis activities, economic presence, attributional nexus, electronic nexus, agency, and partnership and independent contractor activities.

A sampling of recent cases is illustrative of the breadth of nexus issues, as well as the aggressiveness of taxing jurisdictions in targeting nonfilers. In Petition of Borders Online, Inc., California State Board of Equalization, September 26, 2001, an out-of-state internet retailer was deemed to have sales/use tax nexus because an affiliate acted as the internet retailer's authorized representative in the state by accepting returned merchandise on behalf of the internet retailer. In The Reader's Digest Association, Inc. v. Franchise Tax Board, California Court of Appeal, Third District, December 31, 2001, an out-of-state parent corporation was subject to corporate income/franchise tax based on the presence in the state of its wholly owned subsidiary that solicited sales of advertising for the parent corporation's magazine. In Petition of Barnes & Noble.Com, California State Board of Equalization, September 12, 2002, an out-of-state internet

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retailer was deemed to have sales/use tax nexus because an affiliate acted as the internet retailer's authorized representative in the state by distributing discount coupons on behalf of the internet retailer. In Kaiser Optical Systems, Inc. v. Michigan Department of Treasury, Michigan Court of Appeals, December 27, 2002, a Michigan subsidiary that merely (1) maintained its books and records at its parent corporation's office in California (for a use and occupancy charge), and (2) had its parent corporation perform its accounting and financial functions in California (for a monthly fee) was deemed to have corporate income/franchise tax nexus in California. Although the analysis was made in determining the application of Michigan's throwback rule, it nevertheless exemplifies an aggressive nexus posture. In Hoffman-LaRoche, Inc. v. Department of Treasury, Michigan Court of Appeals, March 8, 2005, Michigan was able to retroactively apply a new expanded Single Business Tax nexus standard to a taxpayer despite previously issuing administrative guidelines that indicated nexus did not exist for the taxpayer.

Differing jurisdictional views on nexus are not the only catalyst for an unexpected nonfiling assessment. It is not uncommon for a jurisdiction to change its position on nexus (usually to a more aggressive stance) without a taxpayer learning of the new position (for example, New York State recently issued audit guidelines in conjunction with a payroll withholding tax audit initiative that has caught many taxpayers by surprise). Moreover, as years go by, it has been our experience that taxpayers often modify the type or level of activities conducted in a jurisdiction without considering the nexus implications. This can result in a taxpayer unknowingly establishing nexus in a jurisdiction where nexus did not previously exist.

Furthermore, nonfiling exposure may exist even in jurisdictions where nexus has been established by a taxpayer and returns filed. In this regard, a taxpayer may not be aware of all the miscellaneous filings associated with nexus in a jurisdiction, such as business license, gross receipts, payroll expense or telecommunications tax filings. In many instances, the tax impact of these miscellaneous filings can be significant.

The Genetelli Consulting Group assists taxpayers in resolving potential tax liabilities where nexus is the central issue. As a preliminary matter, The Genetelli Consulting Group can evaluate whether potential nonfiling exposure exists, and offer planning alternatives to potentially allow activities to be performed without establishing nexus in a given jurisdiction.

If nonfiling exposure does exist, The Genetelli Consulting Group can initiate a process known as "voluntary disclosure" which can provide a significant benefit to nonfilers. The voluntary disclosure process allows a taxpayer to approach a taxing jurisdiction anonymously. An agreement is negotiated with the taxing jurisdiction in which the taxpayer agrees to file returns (or provide return information) and pay back taxes for a limited number of years (typically the 3 or 4 most recent years, however, in certain factual situations, even more favorable terms may be obtained), and timely file and pay taxes on a going forward basis. In return, the taxing jurisdiction agrees to waive unpaid taxes for years prior to those covered by the agreement, as well as all penalties that could be imposed. Interest on the taxes paid pursuant to the agreement is generally required, although in certain cases, interest can be waived by the taxing jurisdiction.

Taxes that may be eligible for voluntary disclosure include income, franchise, sales/use, gross receipts, telecommunications, property, payroll withholding and intangibles taxes.

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Confidentiality is preserved during the voluntary disclosure process by not revealing the name of the taxpayer or any information that could identify the taxpayer until the voluntary disclosure agreement is finalized. In certain instances, voluntary disclosure can be initiated on a multijurisdictional basis.

The Genetelli Consulting Group has vast experience throughout the country in negotiating voluntary disclosure agreements. With the proper representation, taxpayers can minimize nonfiling exposure and achieve compliance on a going forward basis. The Genetelli Consulting Group also has long-standing relationships with key administrators that can help expedite the voluntary disclosure process.

If you have any questions or would like to discuss the application of nexus principles to your company's activities (including the quantification of potential nexus exposure and the benefit that can be obtained by voluntary disclosure), please do not hesitate to contact The Genetelli Consulting Group. Also, if you believe your company would benefit from voluntary disclosure, and would like experienced representation in negotiating agreements with the taxing jurisdictions, please do not hesitate to contact The Genetelli Consulting Group. I can be reached at (212) 684-4111.

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