Just Say No to the Standard Voluntary Disclosure Agreement

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In this article, Kranz, Smith, and Capouet argue that states should revise their voluntary disclosure program rules to create flexibility and encourage taxpayers to become registered.

Normally, this column is reserved for thoughts on legal and policy developments in the state tax arena. This month we're frustrated and following David Brunori's well-worn path of using the power of the pen to express our opinion. Our frustration involves a shortsighted approach by some states that are seemingly more reluctant than others to consider and accept voluntary disclosure agreements (VDAs) with less than a standard lookback period. While we praise states for offering VDA programs, a one-size-fits-all approach erodes their value and discourages participation. Some would say the rigid approach cuts off the nose to spite the face.

It goes without saying that one goal of VDA programs is to encourage unregistered taxpayers unknown to the state to voluntarily comply with tax laws (which may or may not apply to those taxpayers). The programs by nature are largely intended to allow taxpayers to come forward and comply regardless of their past sins or ignorance. For some taxpayers — especially those who have been clearly ignoring the law while having unquestionable nexus — a standard deal is a great one. For other taxpayers — when the failure to comply with the tax law is unintentional or when nexus itself is questionable — a standard deal is no deal. This article is intended to encourage those who administer VDA programs to consider and, when appropriate, accept VDA proposals that have less than a standard lookback. Along those lines, VDA administrators should recognize that nexus is not a yes-or-no dichotomy like being pregnant; rather, nexus has more than 50 shades of gray — each with varying degrees of risk and certainty.

VDA programs should be administered in a way that reflects the risk and uncertainty of a taxpayer's potential exposure. In a real way, a standard lookback period should be viewed as the starting point in a negotiation, and the period could shorten or lengthen based on the taxpayer's position and the risk of litigating that position. Taxpayers that face detection risk and certain liability should be happy to get a standard lookback deal. Similarly, a state that is unlikely to detect a foreign taxpayer's nominal activity or a state with a tenuous claim of jurisdiction over a taxpayer should be happy to get prospective compliance. Between these two ends of the spectrum lie the vast majority of cases.

Unfortunately, the prevailing take-it-or-leave-it standard lookback approach discourages taxpayers from participating at all. For example, we recently assisted a client willing to consider collecting sales tax and paying income tax in all states where it was not registered. The company's business model had changed, and the tax department wanted the certainty of filing over the uncertainty of continuing to rely on a de minimis nexus standard.

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Rather than doing a deep factual investigation into the activities taking place in each state, the company approached us to determine whether it could register to begin collecting sales tax and paying income tax prospectively. As advisers, we could not allow it to simply register and begin filing returns and making payments to the state, knowing that the majority of state registration forms ask questions that force taxpayers to identify when they started making sales into the state or otherwise determine if they had nexus risk before registration. Instead, we approached some states seeking a prospective compliance agreement — to place the taxpayer on the tax rolls for both income and sales tax —

and eliminate the possibility of backward-looking exposure if the activities taking place in any state were more than de minimis.

While a few states were willing to entertain and enter into such an agreement, the majority responded with standard lookback pablum. The refusal to even consider an agreement for a shorter time period than the standard lookback led the company to continue its current position — based on a belief that the activities were de minimis and the company therefore does not have sufficient nexus to obligate it to register. While the company would gladly have registered and complied prospectively, and may have agreed to some backward-looking liability, it was impractical to explore whether there were activities taking place in each state. Similarly, companies with transient property that moves through states, or employees and independent contractors that occasionally travel into states if only to purchase goods or services from in-state vendors, may create nexus — but who can be certain that these activities are not de minimis? In short, there are many situations that would justify a VDA to avoid risk and uncertainty, but not all of those situations deserve a three- or four-year lookback.

This problem is not one involving the individuals responsible for administration of the VDA programs, but one caused by the program terms. Tax administrators should not be hamstrung by a lookback policy that ignores the reality of risk. If someone anonymously offers to start throwing money at you, is the right response: "Only if you throw three additional years' worth of money"? Or is it: "How soon will you send the check?" It is time for states to redesign the flexibility of their VDA programs. And it is time for practitioners to tell their clients to just say no to a standard lookback VDA. ✰