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Charting the Course for Multistate Voluntary Disclosures

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In this installment of Noonan's Notes, the authors examine questions about eligibility, lookback periods, and other issues regarding multistate voluntary disclosure programs, and go behind the curtain to walk through how these programs generally work, as well as discuss some of the costs and benefits of taking part in them.

Often in the state and local tax world, some cleanup duty is required. As states get more and more aggressive, and cases like *Wayfair*[1] expand taxpayers' multistate compliance obligations, more businesses are forced to confront the skeletons in their SALT closets. And because of a growing awareness of these concerns, we've also seen an increased focus on SALT issues in the mergers and acquisitions area, as due diligence efforts key into targets' potential past noncompliance regarding multistate sales tax or corporate income tax.

So what tools are there to help with this cleanup duty? Perhaps the best one, and the one we'll focus on in this month's column, is the voluntary disclosure process. Voluntary disclosure programs provide an opportunity for businesses and individuals with unresolved state tax obligations to voluntarily submit past-due information and clear overdue tax debts. These programs are generally available for multiple tax types, including:

- personal income tax;
- withholding tax;
- corporate franchise/income tax;
- sales and use tax; and
- related local taxes.

In return for coming forward voluntarily, taxpayers can receive valuable financial benefits and avoid risks of further liability.

While nearly every state has established a voluntary disclosure program, they all operate in different ways, and questions about eligibility, lookback periods, and other issues will differ from state to state. In this article, we'll chart out how a lot of these different questions are resolved on a state-by-state basis. We'll also go behind the curtain to walk through how these programs generally work, and we'll discuss some of the costs and benefits of taking part in them.

[1] *South Dakota v. Wayfair Inc.*, 585 U.S. ___, 138 S. Ct. 2080 (2018).

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Eligibility

The first set of questions to tackle in any voluntary disclosure analysis involve eligibility. To qualify for a voluntary disclosure agreement (VDA), taxpayers generally cannot be under audit or have been contacted previously by the state's tax department regarding the taxes they hope to disclose. That's the "voluntary" aspect of a VDA; if the state has already contacted you, your willingness to disclose your noncompliance seems a bit less voluntary! So taxpayers should be cognizant of audit letters, nexus questionnaires, assessments, and other correspondence from various state tax departments indicating they are the subject of an audit or review. If you receive one of these letters, it may, unfortunately, be too late for a VDA.

Also, some states won't let a taxpayer into a VDA program if the taxpayer is already registered with the state for the tax type at issue. The idea here, albeit one that's a little shortsighted, is that the state will allow taxpayers into a VDA only if they aren't otherwise on the state's radar. But as we'll see, a lot of states will let registered taxpayers in the door anyway, and in some states, even ineligible taxpayers may qualify for other special accommodations.

Anonymity also will vary from state to state. Some states allow taxpayers to come forward anonymously before disclosing their identity. Others require disclosure upfront. For the inexperienced practitioner or taxpayer, the disclosure requirement sometimes comes as a shock, and some get worried that this gives a state an incentive to deny a taxpayer entry into a VDA and just throw the book at them anyway! But in practice, we don't see this happen. And why would it? States want to encourage this kind of voluntary compliance. If they used these kinds of programs as traps to catch noncompliant taxpayers, no one would ever use them. Whatever the case, it helps to know upfront what states require upfront disclosure as part of the VDA process.

We've charted out how these two questions play out on a state-by-state basis in Table 1.

Table 1. VDA Eligibility

State	Anonymous Application?	Are Registered Taxpayers Eligible for Voluntary Disclosure?
Alabama	Yes	No
Alaska	Yes	No
Arizona	Yes	Yes
Arkansas	Yes	Yes
California	Yes[a]	No
Colorado	Yes	Yes
Connecticut	Yes	Yes
Delaware	Yes	N/A
Florida	Yes	Yes
Georgia	Yes	Yes
Hawaii	Yes, subject to audit[b]	Yes
Idaho	Yes	Yes
Illinois	Yes	Yes
Indiana	Yes	No

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Table 1. VDA Eligibility *(Continued)*

State	Anonymous Application?	Are Registered Taxpayers Eligible for Voluntary Disclosure?
Iowa	Yes	Yes
Kansas	Yes	Yes
Kentucky	Yes	Yes
Louisiana	Yes	Yes
Maine	Yes	Yes
Maryland	Yes	Yes
Massachusetts	Yes	No
Michigan	Yes	No[c]
Minnesota	Yes	No
Mississippi	Yes	No
Missouri	Yes	No
Montana	Yes	Yes
Nebraska	Yes	No
Nevada	No	No
New Hampshire	Yes	Yes
New Jersey	Yes	No
New Mexico	No[d]	Yes
New York	No	Yes
North Carolina	Yes	No
North Dakota	Yes	No
Ohio	Yes	Yes
Oklahoma	Yes	No
Oregon	Yes	Yes
Pennsylvania	Yes	No
Rhode Island	Yes	No
South Carolina	Yes	No
South Dakota	Yes	No
Tennessee	Yes	No
Texas	Yes	Yes
Utah	Yes	Yes
Vermont	Yes	Yes
Virginia	Yes	Yes, but on a case-by-case basis

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Table 1. VDA Eligibility *(Continued)*

State	Anonymous Application?	Are Registered Taxpayers Eligible for Voluntary Disclosure?
Washington	Yes	No
West Virginia	Yes	No
Wisconsin	Yes	No
Wyoming	Yes	No

[a]Out-of-state applicants may obtain a written opinion letter as to whether the California Department of Tax and Fee Administration would approve a voluntary disclosure request based on circumstances presented anonymously. California Department of Tax and Fee Administration, Out-of-State Voluntary Disclosure Program.

[b]If an audit is initiated on a taxpayer who has anonymously contacted the Hawaii Department of Taxation, the taxpayer no longer qualifies for the voluntary disclosure program. Hawaii Department of Taxation, Tax Information Release No. 2020-03.

[c]Michigan resident taxpayers may instead apply for Michigan's Taxpayer-Initiated Disclosure program.

[d]Taxpayers in New Mexico can participate in a "managed audit," which allows taxpayers to conduct an audit on themselves under a signed agreement between the taxpayer and the New Mexico secretary of taxation and revenue. New Mexico Taxation and Revenue Department Publication FYI-404 provides an overview of the program.

Benefits of Voluntary Disclosure

If taxpayers choose to voluntarily come forward, they have the opportunity to gain multiple benefits. Benefits can include:

Limited lookback. States generally limit the scope of the "lookback" period, that is, the years for which the state can assess overdue tax. In some cases, an eligible taxpayer who owes taxes for years before the lookback period can eliminate historic tax debts altogether and may be required to pay only the taxes owed for the limited lookback period. Some states, such as New York, require the taxpayer to request a limited lookback period when applying for the program.

Civil penalty waiver. In exchange for taxpayers voluntarily disclosing and agreeing to pay past tax liabilities, states often agree to waive civil penalties that would otherwise be imposed. Some states waive a percentage of penalties while other states agree to knock out the civil penalties entirely. And in some cases, it's also possible to obtain a penalty waiver even in cases where there is collected but unremitted sales tax (which is a precarious position). A limited lookback, however, is never available in cases involving collected and unremitted tax. This makes sense. States aren't going to allow vendors to enrich themselves at the expense of the state as part of the VDA process.

No criminal prosecution. A significant incentive for taxpayers participating in a voluntary disclosure program is protection from criminal tax prosecution. Many states include in their VDAs that the taxpayer will not be subject to criminal tax prosecution if the taxpayer complies with the terms of the agreement.

Full compliance. Finally, when a taxpayer enters into a VDA with a state, there is the added assurance that the taxpayer (or, in the case of mergers and acquisitions, the successor entity) will be fully compliant with their state tax obligations. By coming clean, taxpayers get a clean bill of health as it relates to possible assessments, penalties, and criminal tax prosecution.

The two big questions that come up here and that often vary from state to state involve the lookback period and whether the abatement of penalties is available for taxpayers with collected but unremitted sales tax. We've charted out answers to these questions in Table 2.

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Table 2. VDA Benefits

State	Standard VDA Lookback Period	Penalty Abatement Available for Collected Tax?
Alabama	3 years (or 36 months)	Yes (extended lookback)
Alaska	5 years	N/A
Arizona	4 years (or 48 months)	Yes (extended lookback)
Arkansas	3 years (or 36 months)	Case-by-case (extended lookback)
California	3 years (or 36 months)	Case-by-case (extended lookback)
Colorado	3 years (or 36 months)	No (reduced penalty available)
Connecticut	3 years (or 36 months)	Yes (extended lookback)
Delaware	5 years	N/A
Florida	3 years (or 36 months)	No (reduced penalty available)
Georgia	3 years (or 36 months)	Yes (extended lookback)
Hawaii	10 years	Case-by-case (extended lookback)
Idaho	3 years (or 36 months)	Yes (extended lookback)
Illinois	4 years (or 48 months)	Yes (extended lookback)
Indiana	3 years (or 36 months)	Case-by-case (extended lookback)
Iowa	5 years (or 50 percent of exposure period)	Yes (extended lookback)
Kansas	3 years (or 36 months)	Yes (extended lookback)
Kentucky	4 years (or 48 months)	Yes (extended lookback)
Louisiana	3 years (or 36 months)	Case-by-case (extended lookback)
Maine	3 years (or 36 months)	Yes (extended lookback)
Maryland	4 years (or 48 months)	Yes (extended lookback)
Massachusetts	3 years (or 36 months)	No (ineligible if tax was collected)
Michigan	4 years (or 48 months)	Yes (extended lookback)
Minnesota	3 years (or 36 months)	Case-by-case (extended lookback)
Mississippi	3 years (or 36 months)	Yes (extended lookback)
Missouri	4 years (or 48 months)	Yes (extended lookback)
Montana	5 years	N/A
Nebraska	3 years (or 36 months)	Yes (extended lookback)
Nevada	8 years	Yes (extended lookback)
New Hampshire	3 years (or 36 months)	N/A
New Jersey	4 years (or 48 months)	No (reduced penalty available)
New Mexico	N/A (Managed Audit Program)	Case-by-case (extended lookback)

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Table 2. VDA Benefits *(Continued)*

State	Standard VDA Lookback Period	Penalty Abatement Available for Collected Tax?
New York	3 years (or 36 months)	Yes (extended lookback)
North Carolina	3 years (or 36 months)	No (reduced penalty available)
North Dakota	3 years (or 36 months)	Yes (extended lookback)
Ohio	3 years (or 36 months)	No (reduced penalty available)
Oklahoma	3 years (or 36 months)	Yes (extended lookback)
Oregon	3 years (or 36 months)	N/A
Pennsylvania	3 years (plus current year)	Yes (extended lookback)
Rhode Island	3 years (or 36 months)	Yes (extended lookback)
South Carolina	3 years (or 36 months)	Yes (extended lookback)
South Dakota	3 years (or 36 months)	No
Tennessee	3 years (or 36 months)	Case-by-case (extended lookback)
Texas	4 years (or 48 months)	Yes (extended lookback)
Utah	3 years (or 36 months)	Yes (extended lookback)
Vermont	3 years (or 36 months)	Case-by-case (extended lookback)
Virginia	3 years (or 36 months)	Case-by-case (extended lookback)
Washington	4 years (or 48 months)	No (ineligible if tax was collected)
West Virginia	3 years (or 36 months)	Case-by-case (extended lookback)
Wisconsin	4 years (or 48 months)	Case-by-case (extended lookback)
Wyoming	3 years (or 36 months)	No (reduced penalty available)

A Case Study

When considering a multistate cleanup that involves one or more voluntary disclosure programs, it is important not to prematurely begin submitting applications without first charting a strategy for success. Taxpayers should instead first analyze their business operations and infrastructure to determine the states where they have a physical presence or where the business's revenue exceeds the applicable economic nexus thresholds. In determining whether there is sufficient exposure to warrant a VDA, the taxpayer must consider whether their sales are subject to sales and use tax in a particular state. And then there are a variety of strategic and practical considerations to account for.

The NFL season is now upon us (Go Bills!), so how about a football-related hypothetical? Here's the situation. You operate a retail business that sells officially licensed NFL products. What you consider to be your "business," that is, your physical storefront and employees, is located in western New York. However, a significant portion of your revenue is driven by online sales to other states. You (and your accountant) have assumed for many years that because you have no physical presence in any other state, the only state in which you have an obligation to collect and remit sales tax and to file income tax returns is New York. Well, before 2018, you might have been correct. But in the wake of *Wayfair*, with nearly every state establishing economic nexus thresholds, you might be on the hook for a

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significant multistate tax liability if you're not paying attention.

Let's say that since 2018, your sales of Josh Allen jerseys have steadily increased in the quarterback's native state of California. And in 2022, with Allen headlining the NFL's list of top-selling jerseys, you sold $1 million worth of #17 jerseys in Allen's native state (that's a lot of $130 jerseys). You panic as you realize that, not only for tax year 2022 but for each year since 2018, your business exceeded California's economic nexus threshold of $500,000 of in-state sales. How should you address this potentially significant tax liability? And what if you have a potential buyer looking to acquire your otherwise successful business?

Should you file a voluntary disclosure application in California? And what about other states? You've had sales around the country since 2018, but really your revenue only started to ramp up in locations beyond New York and California last year. Before 2022, it's possible that your revenue slightly exceeded the *Wayfair* thresholds in some states, but sales were generally pretty low on a state-by-state basis — in the $100,000 range. So it's possible that there are several states where the exposure is only about $5,000 or so per year.

So what should be the strategy here? For California, the answer is easy. This is an obvious case where a VDA provides significant benefits. The potential tax alone in California could be close to $100,000 per year going all the way back to 2018, and penalties could add a lot more. Doing a voluntary disclosure not only allows you to eliminate potential penalties, but it should also allow you to limit the lookback based on California's three-year lookback period. Thus, for California, the VDA process is the way to go.

As for other states, we could certainly go the same direction and go through the VDA process in every state to clean up the various messes. The other possibility is that you could just fix it now, on a prospective basis, and start collecting the tax going forward. Ultimately this often becomes a business decision involving a thoughtful cost-benefit analysis. Indeed, although VDA processes across the various states work very well, if you have to do 15 or 20 of them it can get expensive from a professional fee standpoint. And if you are only cleaning up $5,000 or $10,000 in tax on a per-state basis, you may spend something close to the tax amount in each state just paying professionals to do work that produces little, if any, benefit. Moreover, unlike the situation with California, you don't have a long lookback period covering several years for which there's potentially hundreds of thousands of historic (pre-lookback) dollars at issue. Thus, even if a handful of states came after you in a couple of years for the relatively small tax liabilities dating back to 2021 or 2022 (which you'd end up owing through a VDA regardless), paying to resolve the liabilities in those handful of states probably ends up being cheaper than cleaning things up in 15 or 20 states now.

That said, many other considerations can come into play here. Most notably is that if you're looking to sell your company in a couple of years, the prospective buyer will likely insist that all skeletons in your closet be cleaned up before closing on a deal. And the buyer can create lots of complications and hassles during the due diligence process, requiring escrows, holdbacks, and even subsequent VDAs with the buyer looking over your shoulder every step of the way. So if you are looking at a sale down the road, it might make sense to do VDAs in the 15 or 20 states at issue to: (1) control the process yourself, and (2) avoid potentially painful (and expensive) hassles in the future.

One other consideration that can be particularly helpful in situations in which VDAs in multiple states are necessary is the Multistate Tax Commission's Multistate Voluntary Disclosure Program. This program allows taxpayers with potential tax liability in multiple states to apply for VDAs using a uniform procedure coordinated through the MTC's National Nexus Program. Advantages to the MTC's program include a streamlined application and registration process. The program, however, excludes several states, such as New York and California. And since the MTC operates as an intermediary throughout the process, there is often a lack of direct contact with the state-specific voluntary disclosure representatives. Again, these are decisions to consider before starting the VDA process.

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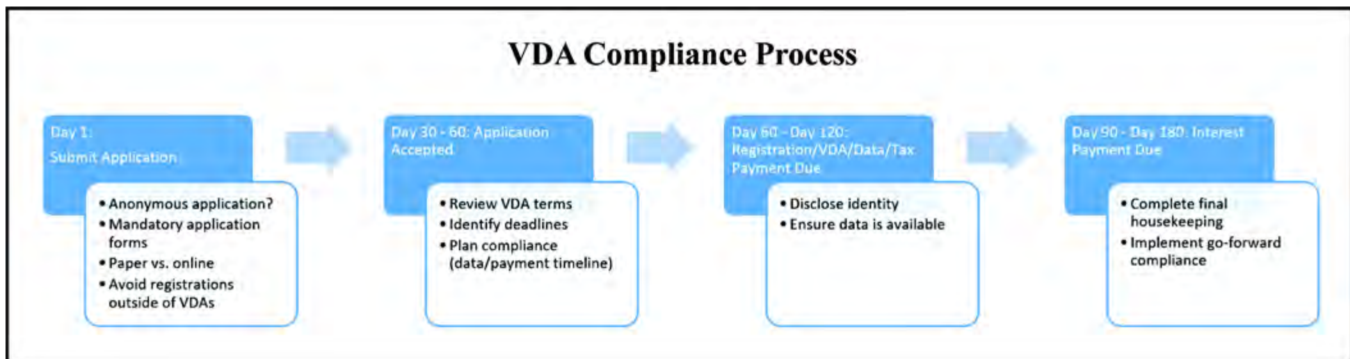

Voluntary Disclosure Timeline

Finally, a word about process and timing. We've charted out in the figure below how the VDA process generally transpires. Here's how it works:

Step 1: Apply. Typically, taxpayers that meet the state's eligibility criteria and opt to pursue voluntary disclosure will be required to submit an application that includes a detailed explanation of the taxes owed. Some states require an explanation of any reasonable cause for the failure to file and pay the appropriate taxes. It is important to organize, monitor, and prioritize relevant voluntary disclosure deadlines from the start.

Step 2: Wait. The waiting period before an application is accepted is generally around 30 to 60 days. During this period, the taxpayer should gather relevant data (for example, begin preparing the returns, work papers, or spreadsheets) required by the states.

Step 3: Acceptance, review, and registration. Generally, when the state approves the taxpayer's application, the state sends the taxpayer a formal VDA. The agreement outlines the taxpayer's duty to comply with the state's tax obligations in the future. The taxpayer and its representatives should review the final VDA terms. After acceptance, the taxpayer may then be required to register for all appropriate tax accounts.

Step 4: Disclosure of identity, tax returns (or schedules), and payment. Finally, in states with anonymous applications, the taxpayer will have to disclose their identity and pay the tax and interest due. Tax returns may also be required at this stage, though many states accept schedules or summaries of the taxes due. Payment plans are sometimes available as well.

As laid out above, the VDA process can be long and complicated. But when executed properly, and with the right amount of planning and analysis, the potential benefits are often well worth the hassle. ■

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