Setting the Record Straight — Evidentiary Pitfalls in SALT Litigation

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In two recent cases, courts in New Jersey and Ohio that prohibited reliance on evidence that wasn't provided during audit have hamstrung taxpayers' ability to litigate their state tax claims. As illustrated by these cases and the state tax laws discussed below, the point at which the evidentiary record is established in a state or local tax case varies significantly among state and local jurisdictions. To make matters worse, the statutes, regulations, and rules relating to the evidentiary record are unclear. In this installment of our column, we highlight the risks that are associated with establishing a record in a state or local tax dispute — and the consequences of failing to do so.

Background

The point at which the evidentiary record is established can vary by jurisdiction and by tax type. In California, for example, a taxpayer may challenge an assessment of franchise or income tax by appealing to the State Board of Equalization.[1] The BOE's jurisdiction in those cases is limited to determining the correct amount owed by or due to the taxpayer, but its review of the Franchise Tax Board's determination of liability is trial *de novo*.[2] In contrast, a taxpayer challenging a determination by a California county board of equalization may present new evidence to a reviewing trial court, depending on the nature of the case. The board's factual findings are reviewed under the substantial evidence standard, but its decisions on questions of law are reviewed *de novo*.[3] When the substantial evidence standard applies, the trial court's review is limited to the record presented to the board.[4] When review is *de novo*, the court may receive additional evidence regarding the legal issue at hand.[5]

In Georgia a taxpayer may appeal tax assessments to the Georgia Office of State Administrative Hearings and have its case heard by an administrative law judge.[6] The ALJ's hearing is *de novo*, and the evidence that may be presented is not limited to that presented to or considered by the Georgia Department of Revenue.[7] Generally, the record closes at the end of the evidentiary hearing, but if the ALJ requires a party to submit proposed findings of fact, the record closes on the deadline for filing those findings.[8] The ALJ's decision is treated as an initial decision,[9] meaning that the Georgia commissioner of revenue reviews the ALJ's decision and may modify or reject the proposed findings of fact, in whole or in part.[10] The commissioner may

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[1]Calif. Revenue and Taxation Code section 19046.

[2]*In re Boca Land Co.*, Case No. 31-SBE-014, at 2-3 (Calif. Board of Equalization, May 11, 1931). In *Barry v. Commissioner*, a decision cited favorably by the BOE in *Boca Land Co.*, the U.S. Board of Tax Appeals stated: "To say that the taxpayer who brings his case before the Board is limited to questions presented before the Commissioner, and that the Board in its determination of the case is restricted to a decision of issues raised in the Internal Revenue Bureau would be to deny the taxpayer a full and complete hearing and an open and neutral consideration of his case." 1 B.T.A. 156, 157 (1924).

(Footnote continued in next column.)

[3]*Maples v. Kern Cnty. Assessment App. Bd.*, 96 Cal. App. 4th 1007, 1013 (Cal. Ct. App. 2002).

[4]*Norby Lumber Co. v. Cnty. of Madera*, 202 Cal. App. 1352, 1362 (Cal. Ct. App. 1988).

[5]*Id.* at 1363.

[6]Ga. Code Ann. section 50-13-41(a)-(b).

[7]Ga. Comp. R. & Regs. r. 616-1-2-.21(3).

[8]*Id.* rr. 616-1-2-.24, -.26.

[9]Ga. Code Ann. section 50-13-41(d); Ga. Comp. R. & Regs. r. 616-1-2-.27.

[10]Ga. Code Ann. sections 50-13-17(a), 50-13-41(d).

also take more testimony if necessary.[11] Although taxpayers may appeal the commissioner's final decision to a superior court,[12] review by the superior court is confined to the record established in the hearing before the ALJ.[13]

In contrast to the Georgia rules, in North Carolina, following an appeal to the Office of Administrative Hearings, the taxpayer may present additional arguments to the revenue secretary.[14] However, the secretary may not hear new evidence.[15]

Failure to Disclose Information During Audit

Must a taxpayer provide all evidence during an audit that it may wish to use later in court? Does the taxpayer have to present all supporting evidence when appealing a determination by the state tax authority? What should be the evidentiary scope of a court's review in state tax cases? Sometimes taxpayers may not worry about establishing an evidentiary record until a case proceeds to court, operating under the assumption that the evidentiary record is established in litigation. However, as is demonstrated by *United Parcel Service General Services Co. v. Director, Division of Taxation* (*UPS*),[16] and *Ohio Bell Telephone Co. v. Levin* (*Ohio Bell*)[17] overlooking that significant procedural issue can be a harsh trap for unwary taxpayers.

Auditors generally have broad statutory authority to examine, and request information relating to, taxpayers' books and records.[18] In New Jersey, the director of the Division of Taxation may examine or investigate the books, records, papers, vouchers, accounts, and documents of any taxpayer.[19] But to what extent can the auditors' expansive inspection and examination authority affect the evidentiary record if the case proceeds to litigation?

[11]*Id.,* section 50-13-17(a).

[12]*Id.,* section 50-13-19(b).

[13]*Id.,* section 50-13-19(g). Parties may apply for leave to present additional evidence, but they must demonstrate to the court's satisfaction that the evidence to be presented is material and that good reasons existed for the party's failure to present it to the ALJ. *Id.* section 50-13-19(f).

[14]N.C. Gen. Stat. section 150B-36(a).

[15]*Id.,* section 150B-36(b2), (b3).

[16]25 N.J. Tax 1 (June 5, 2009). (For the decision, see *Doc 2009-14855* or *2009 STT 124-21*.)

[17]*Ohio Bell Tel. Co. v. Wilkins*, 2007 Ohio Tax LEXIS 1207 (Ohio Bd. Tax App., Aug. 31, 2007), *rev'd sub nom. Ohio Bell Tel. Co. v. Levin,* 124 Ohio St. 3d 211 (Ohio S. Ct. 2009). (For the decision, see *Doc 2009-26477* or *2009 STT 231-24*.)

[18]*See, e.g.*, Fla. Stat. section 213.34; Ga. Code Ann. section 48-2-8(a)(4); M. G.L. c. 62C, section 20; N.J. Stat. Ann. section 54:50-2a; N.Y. Tax Law section 1096(b)(1).

[19]N.J. Stat. Ann. section 54:50-2a. *See id.,* section 54:10-10b; N.J. Admin. Code 18:7-11.17(b). ("[The director] may require the production of books, papers, documents and other data, to provide or secure information pertinent to the determination of the tax and its enforcement and collection.")

The New Jersey Tax Court recently held that when a taxpayer purposefully withholds information from a requesting auditor, it cannot later rely on that same information at trial.[20] The case, *UPS*, involved the proper allocation of transportation revenue derived by three UPS subsidiaries for New Jersey corporation business tax purposes.[21] The subsidiaries elected to apportion their income under a special allocation formula for airlines based on departures from the state.[22]

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During an audit of the UPS Group, the auditor made several requests for information regarding the cost and value of the subsidiaries' aircraft in order to determine whether the special allocation formula was applied in a fair and reasonable manner.[23] The three entities refused to provide the requested information on the grounds that weighting based on aircraft cost and value would not provide a fairer and more reasonable business allocation factor.[24] Asserting that use of the departures fraction could distort the subsidiaries' receipts allocable to New Jersey, the auditor used an alternative method for which supporting documentation had previously been provided by one of the subsidiaries.[25] The auditor also used information found on the Internet to further supplement her calculations.[26]

When the case reached the tax court, the subsidiaries attempted to rely on the cost and value information they previously withheld from the New Jersey auditor.[27] First noting the director's statutory and regulatory right to obtain information from taxpayers for purposes of determining, enforcing, and collecting tax, the tax court prohibited UPS from relying on information not provided to the state

[20]*UPS*, 25 N.J. Tax at 41.

[21]*Id*.

[22]New Jersey law requires that airline transportation revenue from services performed in New Jersey be apportioned based on the ratio of departures from New Jersey to total departures in order to achieve a fair and reasonable receipts fraction. N.J. Admin. Code 18:7-8.10(c)(4)(i). Alternatively, "departures may be weighted as to cost and value of aircraft by type where weighting would give a more fair and reasonable business allocation factor." *Id.*

[23]25 N.J. Tax at 42.

[24]*Id*.

[25]*Id.,* at 43.

[26]*Id*.

[27]*Id.*, at 42.

during the audit. UPS argued that it withheld the cost and value information from the auditor out of concern for the confidentiality of the information, an argument that the tax court summarily dismissed.[28] The court held that the state's laws requiring tax information to be kept confidential were sufficient to protect the requested information.[29]

The tax court's decision concerns us because it is punitive and violates fundamental notions of fairness, especially given the statutory directive that the court "shall determine all issues of fact and of law *de novo*."[30] Disputes between taxpayers and state tax administrators typically relate to overbroad information requests that leave taxpayers uncertain of where to begin. The tax court decision could result in heavy-handed and broadly defined information requests with severe consequences for failing to comply.

The tax court reached its decision by analogizing the circumstances of the case to those addressed by N.J. Stat. Ann. section 54:4-34, which authorizes local property tax assessors to make a reasonable assessment using available information when certain information requested from the taxpayer is unforthcoming. The effect of this statute, according to the tax court, is that a taxpayer may appeal only the issue of whether the assessment was reasonable based on the information available to the assessor. Thus, evidence not made available to the assessor cannot be used in evaluating the assessment.[31] That may be so for local property tax purposes, but the tax court seems to have overlooked a critical distinction: The New Jersey State Legislature did not convey similar power to state auditors in the context of the corporation business tax.[32] The court's willingness to unilaterally extend the application of the rule is troubling, especially in light of the harsh result.

The theory underlying the *UPS* decision is not without precedent. Federal law contains a similar provision, I.R.C. section 982, which addresses the admissibility of documentation maintained in foreign countries. The statute provides that if a taxpayer fails to "substantially comply" with a formal document request (FDR) from the IRS within 90 days, any foreign-based documentation covered by the request cannot be introduced in any civil court proceeding on the tax treatment of the examined item.[33]

Section 982 does not define substantial compliance, but, unlike the New Jersey Tax Court's judicially created evidentiary bar, it contains a reasonable cause exception.[34] For example, information that is not provided to the IRS under an FDR may still be allowed in court if the scope of the FDR is unreasonable,[35] whereas under the *UPS* categorical bar, the reasonableness of an auditor's request for information and production of documents does not appear to be a required consideration.

Failure to Present Information When Appealing a Tax Assessment to the State Tax Authority

In *Ohio Bell*, the Ohio Supreme Court held that a taxpayer must set forth as error in its notice of appeal to the Board of Tax Appeals (BTA) the factual basis that forms the grounds for its appeal. The court refused to consider the taxpayer's arguments even though state law provides for a trial *de novo* when appealing the commissioner's final determination to the BTA.

In 2003 the Ohio tax commissioner issued a preliminary property tax assessment to Ohio Bell Telephone Co. (Ohio Bell), substantially increasing the taxable value of its property.[36] Ohio Bell petitioned for reassessment on the grounds that the commissioner's determination failed to reflect the true value of its taxable property and that the determination was "erroneous, unjust and unreasonable" for overstating costs and service lives and using a valuation method that did not reasonably reflect true value.[37]

Ohio Bell submitted a depreciation replacement cost study (Study 1) to the commissioner reflecting a substantial reduction in value from that alleged by the commissioner.[38] The commissioner denied Ohio Bell's petition. The company then filed a notice of

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[28] *Id.,* at 47.

[29] States often share information with each other, the IRS, nongovernmental entities like the Multistate Tax Commission, and in some cases, third-party auditors. However, in our experience, such statutory and regulatory provisions have proven insufficient in preventing the unauthorized disclosure of confidential information by state tax authorities. Stay tuned for another A Pinch of SALT specifically addressing this issue.

[30] N.J. Stat. Ann. section 2B:13-3(b).

[31] 25 N.J. Tax. at 46 (citing *Ocean Pines, Ltd. v. Borough of Point Pleasant*, 112 N.J. 1 (1988)).

[32] The New Jersey Supreme Court described the purpose of N.J. Stat. Ann. section 54:4-34 as encouraging compliance with assessors' property requests for information and increasing the efficiency of the assessment process. *Ocean Pines, Ltd.*, 112 N.J. at 7. The New Jersey Tax Court has also extended the "logic" of the New Jersey Supreme Court's interpretation of N.J. Stat. Ann. section 54:4-34 to sales and use tax assessments.

[33] 26 U.S.C. section 982(a). For an application of the evidentiary bar contained in 26 U.S.C. section 982, see *Eulich v. United States*, 74 Fed. Appx. 373 (5th Cir. 2003); *Flying Tigers Oil Co., Inc. v. Comm'r*, 92 T.C. 1261 (U.S. Tax Ct. 1989); and *Int'l Marketing Ltd. v. United States*, 1990 U.S. Dist. LEXIS 14710 (1990).

[34] 26 U.S.C. section 982(b)(1).

[35] *Id.*

[36] 124 Ohio St. 3d at 213; 2007 Ohio Tax LEXIS 1207, at *2.

[37] 124 Ohio St. 3d at 213.

[38] 2007 Ohio Tax LEXIS 1207, at *2; 124 Ohio St. 3d at 214.

appeal with the BTA, specifying two errors, the second of which was as follows:

> The cost less depreciation method utilized by the Tax Commissioner does not reflect the true value in money of Ohio Bell's taxable property as required by Ohio law. The Tax Commissioner's determination is erroneous, unjust and unreasonable because, *inter alia*, it overstates both costs and service lives and utilizes a method that does not reasonably reflect true value.[39]

On appeal, Ohio Bell provided Study 1 to the BTA in support of its position.[40] After the notice of appeal was filed, but before of the BTA hearing, another case involving a different taxpayer was decided that rejected a valuation study similar to Study 1.[41] Later, Ohio Bell had another appraisal of its property prepared using a unit appraisal method (Study 2).[42] The commissioner moved to exclude Study 2 on the grounds that the BTA lacked jurisdiction to decide matters not decided by the commissioner and not specified as error by the taxpayer.[43] In other words, the commissioner argued that because the taxpayer had not presented Study 2 with its petition for reassessment, the matter had not and could not have been decided by the commissioner. Nor did the notice of appeal contain a specification of error based on a failure to consider the unit appraisal method, the commissioner argued. The BTA found Study 2 to be probative evidence and reduced the value determined by the tax commissioner.

The Ohio Supreme Court reversed the BTA's decision[44] and held that Ohio Bell's notice of appeal did not give the BTA jurisdiction to redetermine the total value of Ohio Bell's taxable property.[45] Although the court agreed with the taxpayer that it was not required to give notice of the evidence it intended to present at trial, it found that Ohio Bell's notice of appeal was deficient because it did not specifically include the company's unit appraisal method theory, on which Study 2 was predicated.[46] The court found that the notice was so generic that it did not inform the commissioner's office that it erred by failing to consider the unit appraisal method. Because the BTA lacked the requisite jurisdiction to consider the unit appraisal method, Study 2 could not be considered. [47]

Ohio Bell is problematic for several reasons. First, it appears that the court limited the taxpayer's arguments to the actual language of the notice of appeal. The Ohio statute regarding the notice of appeal provides that a taxpayer appealing from a final determination of the commissioner must specify the errors complained of.[48] Ohio case law has further clarified that this requirement is "jurisdictional" and "stringent" and cannot be entirely "generic."[49] Beyond those relatively amorphous standards, how is a taxpayer to know whether it has drafted its notice of appeal so that it properly invokes the jurisdiction of the reviewing court? *Ohio Bell* does not answer that question.

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Second, the *Ohio Bell* decision appears to preclude a taxpayer from introducing new evidence to the BTA unless it was presented to the tax commissioner.[50] The decision marks a major deviation from prior practice at the BTA. The court hinted that Ohio Bell might have been precluded from presenting evidence of the unit appraisal even if its notice of appeal had been proper. Significantly, however, BTA hearings are *de novo* proceedings, and parties may introduce new evidence.[51] Moreover, "the BTA is statutorily authorized to conduct full administrative appeals in which the parties are entitled to produce evidence in addition to that considered by the Tax Commissioner."[52] Did the court intend for *Ohio Bell* to require taxpayers to have fully developed their

[39]124 Ohio St. 3d at 213 (italics in original).

[40]124 Ohio St. 3d at 213.

[41]*Cincinnati Bell Tel. Co. v. Zaino*, Case Nos. 2003-K-765 and 2003-K-1612 (Ohio Bd. Tax App., June 10, 2005).

[42]124 Ohio St. 3d at 214.

[43]*Id.* 2007 Ohio Tax LEXIS 1207, at *8.

[44]Noting that BTA hearings are *de novo* and that parties may present evidence that was not considered by the commissioner, the BTA denied the commissioner's motion to exclude the taxpayer's evidence and heard testimony on Study 2. 2007 Ohio Tax LEXIS 1207, at 4, 6-*9. The BTA found Study 2 to be probative evidence of the true value of Ohio Bell's property, and it reversed the commissioner's assessment. *Id.* at *11.

[45]124 Ohio St. 3d at 215.

[46]*Id.*

[47]*Id.* at 218. In closing, the court suggested that it might have refused to consider Study 2 even if Ohio Bell had properly specified as error in its notice of appeal the commissioner's failure to apply the unit appraisal method, because Study 2 had not been presented to the commissioner. *Id.* The court ultimately decided to leave that issue for another day.

[48]Ohio Rev. Code Ann. section 5717.02.

[49]124 Ohio St. 3d at 215 (citing *Newman v. Levin*, 120 Ohio St. 3d 127, 132 (Ohio S. Ct. 2008); *Brown v. Levin*, 119 Ohio St. 3d 335, 340, 341 (Ohio S. Ct. 2008)).

[50]*Id.* at 218.

[51]*Higbee Co. v. Evatt*, 140 Ohio St. 325, 332 (Ohio S. Ct. 1942).

[52]*Key Servs. Corp. v. Zaino*, 95 Ohio St. 3d 11, 16 (Ohio S. Ct. 2002) (citing *Bloch v. Glander*, 151 Ohio St. 381, 387 (Ohio S. Ct. 1949)). *See Nestle Co., Inc. v. Porterfield*, 28 Ohio St. 2d 190, 193 (Ohio S. Ct. 1971) (explaining that Ohio Rev. Code

(Footnote continued on next page.)

legal theories and evidentiary record when the notice of appeal is filed with BTA. It certainly seems so. Futhermore, the court perhaps made an unwarranted leap into the legislative arena, because its holding seems at odds with the legislature's wish for *de novo* proceedings before the BTA.[53]

Best Practices for Setting the Evidentiary Record

As demonstrated by *UPS* and *Ohio Bell*, a tax audit may sometimes be the point at which the evidentiary record is established. Therefore, it is often critical to ensure that the taxpayer discloses to the auditor all the relevant information that it intends to rely on during trial and that is available at the time of audit. At the same time, taxpayers must carefully weigh the benefits of withholding information requested by state revenue officials that could prove useful at trial.

Taxpayers may want to provide auditors with information that is not requested by the state auditor. Providing information that helps substantiate a taxpayer's filing position could increase the taxpayer's chances of defending the position in the audit — and just as importantly, avoid the risk of having the helpful information challenged if the matter proceeds to litigation.

Taxpayers also should consider the types of information they may want from state revenue agencies. It is becoming increasingly common for taxpayers to seek information from state revenue officials during an audit that substantiates the state's audit position. Although formal discovery is not part of the audit process, taxpayers are frequently considering requesting information from state revenue officials under freedom of information or open record acts. The advantage of such requests is that they allow the taxpayer to ensure that it is being treated fairly and to ensure that all relevant arguments are made to the state revenue agency as part of the audit.

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Finally, as illustrated by *Ohio Bell*, it is important to ensure that all legal arguments are raised to state revenue officials during audits and appeals. Although state procedural law often does not require that all legal arguments be made during a protest or administrative appeal, in many cases it may be preferable to put the department on notice of those arguments to avoid having them be precluded in litigation.

Conclusion

In light of *UPS* and *Ohio Bell*, taxpayers should consider strategies of providing or withholding information during state or local tax audits and administrative appeals. They should pay particular attention when providing information to auditors and state tax agencies, keeping in mind that under the laws of some jurisdictions, the evidentiary record is developed far in advance of litigation. The best practices discussed above will foster more comprehensive and successful litigation strategies and help taxpayers avoid significant procedural pitfalls. ☆

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Ann. section 5717.03 "authorizes the [BTA] to make its own investigations and findings, independent of those of the Tax Commissioner").

[53]In a decision issued in July of this year, the Ohio Supreme Court purported to clarify its holding in *Ohio Bell*. *WCI Steel, Inc.* v. *Testa,* 2011 Ohio 3280 (Ohio S. Ct. 2011). Expressly noting that BTA hearings are *de novo* and that the BTA may consider evidence not considered by the tax commissioner, the court attempted to explain that its holding in *Ohio Bell* stood for the narrow proposition that a taxpayer cannot present an '"alternative valuation method' that has not previously been presented to the tax commissioner." *Id.* at *30. Yet, the taxpayer in *WC1Steel* was allowed to present to the BTA a second appraisal utilizing an appraisal method different from the appraisal actually reviewed by the tax commissioner. Is this a distinction without a difference, especially when one considers that the issue in these cases is the true value of taxpayers' property? *WCI Steel* does, however, address questions surrounding the sufficiency of a notice appeal by establishing a two-prong standard for properly invoking the jurisdiction of the BTA.