



COST'S 39TH ANNUAL MEETING AND 2008 TAX POLICY CONFERENCE

ANATOMY OF A STATE TAX DISPUTE: BEST PRACTICES IN LITIGATION

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Presented by

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PART ONE



Some Initial Thoughts

- **Develop an Overall Strategy Prior to Audit/Receipt of an Assessment**
 - **Identify Issues When They Arise**
 - **Memorialize the Facts and Your Position for Your Files**
 - **Preserve Privileges**
 - **Classify Issues By Where They Might Best Be Resolved - Audit, Appeals or at Trial**



Some Initial Thoughts

- **Develop An Overall Strategy Prior to Audit/Receipt of An Assessment**
 - **Narrow the Issues Without Highlighting Issues or Assuming They Will be Identified**
 - **Identify “Trade-Off” Issues**
 - **Resist the Auditor’s Efforts to Explore Facts That are Adverse to an Issue**
 - **Educate the Auditor on Favorable Facts**



Some Initial Thoughts

- **Develop An Overall Strategy Prior to Audit/Receipt of An Assessment**
 - **Preserve the Auditor's Errors Until the Most Advantageous Moment for Disclosure**
 - **Avoid Inadvertent Admissions**
 - **Remain Sensitive to Statute of Limitations Issues**
 - **Select the Issues to be Contested Through Refund Claims**



Some Initial Thoughts

■ Know the State's Case

- Obtain as Much Information as Possible About the State's Position
- Meet with the Auditor to Gain Insight and Information
- If Auditor is Not Forthcoming, Consider Use of Freedom of Information Act/Open Records Requests
- Do the Necessary Research



Some Initial Thoughts

■ Settlement?

- **An Opportunity to Settle is Almost Always Available**
- **Generally, the Earlier in the Process the Better**
- **Engage in Discussions Even If It is Only to Gauge the Strength of the State's Case**



Some Initial Thoughts

■ Settlement Structures

- Lump Sum or Flat Dollar Amount
- Percentage of the Tax in Dispute Plus Statutory Interest
- Issue by Issue Resolution



Some Initial Thoughts

■ When Do You Begin Preparing for Litigation?

- Not Upon the Issuance of An Assessment
- When You Recognize an Issue That Could Potentially Lead to Litigation
- This May Be as Early as When a Transaction is Contemplated or Planning Technique Employed
- Certainly When a Return Position is Taken



Some Initial Thoughts

- **Once You Identify an Issue**
 - **Marshall Your Facts Early in the Process**
 - **Marshall Your Fact Witnesses**
 - **Research the Law**
 - **Prepare a Memorandum to the File**
 - **If Necessary, Engage Outside Assistance (Experts, Local Counsel)**



Preparing for Battle

Privilege

- **Attorney Client Privilege**
 - **Generally, an Attorney's Communications With His or Her Client Are Protected Against Disclosure**
 - **The Privilege is Always Governed By State Law**



Preparing for Battle

Privilege

■ Attorney Client Privilege

- **The Person to Whom the Disclosure is Made is a Member of the Bar and is Acting as a Lawyer**
- **The Communication Relates to Facts Learned by the Lawyer**
- **The Privilege Has Not Been Waived by the Client**
- **The Privilege is Always Governed by State Law**
- **A Taxpayer Claiming the Attorney Client Privilege is Generally Required to Show**
 - **The Holder of the Privilege is a Client or Seeks to Become a Client**



Preparing for Battle

Privilege

■ Work Product Doctrine

- **Generally, Documents and Other Materials Containing the Mental Impressions of an Attorney or Other Representative of a Party Are, If Prepared in Anticipation of Litigation, “Work Product” and Not Discoverable.**



Preparing for Battle

Privilege

■ Work Product Doctrine

- **The Privilege May Cover Documents Prepared by Taxpayer or its Attorney, or Those Engaged by the Attorney to Assist, in Anticipation of an Assessment**
- **The Privilege Extends to Documents That May Not Contain Client Confidences and is Arguably Broader than the Attorney Client Privilege**
- **It is the Attorney's Privilege, Not the Client's**

The Battle



The Notice of Assessment

- Establishes the Department's *Prima Facie* Case as to Both the Basis for and Amount of the Assessment
- It is the Taxpayer's Burden to Establish by Competent Evidence that the Department's Assessment is Incorrect



The Battle

What are your options?

- **Concede and Pay the Assessment**
- **Pay and File a Refund Claim**
- **Do Not Pay - Prepare and Timely File a Protest**



Some Initial Thoughts

■ Forum Selection

- **In Some States, Several Alternatives May be Available.**
 - **In Tennessee and Texas, For Example, a Taxpayer May–**
 - **Avail Itself of the Administrative Hearing Process,**
 - **Pay and File a Refund Claim or**
 - **File a Complaint in Chancery Court Contesting the Assessment (Must File Bond, Letter of Credit or Other Security Equal to 150% of Assessment) (Tennessee)**
 - **Pay the Tax Under Protest and File a Lawsuit in District Court (Texas)**



Some Initial Thoughts

■ Forum Selection

– Some Benefits of Administrative Review

- **Tax Need Not be Paid Until There is a “Final Determination” – Interest Stops Accruing While State Considers Case Beyond Statutory Time Limits in Tennessee, but Interest Continues to Accrue in Texas**
- **Further Opportunity to Understand the State’s Position**
- **No Rules of Evidence in Tennessee, but in Texas Rules of Evidence Apply**
- **Often the Least Costly Alternative**
- **Favorable Rulings Cannot Be Appealed in Texas**



Some Initial Thoughts

■ Forum Selection

– Some Detriments to Administrative Review

- Lack of Hearing Officer's Independence
- Cost of Extra Level of Review If Appeal is Taken in Tennessee, but in Texas Trial *De Novo* Applies
- Institutional Tilt Towards the State

Some Initial Thoughts

■ Forum Selection

– Some Benefits to Payment/Claim for Refund Action

- Interest Stops Accruing in Tennessee but not in Texas
- Impartial Judge
- Rules of Evidence Apply
- Eliminates a Level of Review
- Less Costly
- Appellate Court Review
- Some Detriments to Payment/Claim for Refund Action
- Must Pay to Play
- Settlements Somewhat More Difficult



Some Initial Thoughts

■ Forum Selection

– Some Benefits of Prepayment Action

- Impartial Judge
- Rules of Evidence Apply
- Eliminates a Level of Review
- Appellate Court Review



Some Initial Thoughts

■ Forum Selection

– Detriments to a Prepayment Action

- Interest Continues to Accrue at Statutory Rate
- Must Post Bond/Letter of Credit/Adequate Security in Tennessee



Some Initial Thoughts

■ Forum Selection

- **If a Choice is Available, Where Should a Lawsuit be Filed?**
 - **Should Action be Filed in State Capital or in County Where Business has its Principal Offices?**



Some Initial Thoughts

■ Forum Selection

- **If the Issue is Complex, is a Specialized Tax Court Available?**
- **Might This be a Better Choice than a General Trial Court Where the Judge May Not Understand the Technical Nature of a Tax Case?**



Some Initial Thoughts

■ Forum Selection

- **Consider the Rules of Each Forum and Goals of the Taxpayer**
 - **Does the Taxpayer Wish to Seek Discovery?**
 - **Avoid Discovery?**
 - **Are Procedural Rules Better Defined in a Particular Forum?**
 - **Are Stipulations Easier in One Forum?**
 - **Does It Matter?**



The Battle

Discovery

- **Pursue Discovery Informally Through Agreement**
 - **Discovery is Designed to Narrow Issues Through the Exchange of Information**
 - **Proceed on the Principle of Providing Information That Would Otherwise be Available Through Formal Discovery**



The Battle

Discovery

■ Formal Discovery

- **If You Believe the DOR is Withholding Information, Issue Formal Discovery**
- **Formal Discovery Consists of Interrogatories (Written Questions) and Document Requests**
- **At a Minimum, Request the Names of the DOR's Witnesses, Including Experts, and the Documents the DOR Intends to Rely on at Trial**



The Battle

Discovery

■ Formal Discovery

- **If You are Served with Formal Discovery, Serve Formal Discovery on the Department. It Evens the Playing Field and Helps Resolve Disputes**
- **Follow Discovery Up with a Request for Admissions**



The Battle

Discovery Depositions

- **Expect Your Witnesses, Both Fact and Expert, to be Deposed by Opposing Counsel**
- **It is a Rare Case Where Opposing Counsel Will Allow You to Put a Witness on the Stand Without Knowing the Witnesses Testimony in Advance**
- **Depositions Can Also be Used to Impeach Testimony if the Witness' Testimony at Trial Differs From His Testimony at the Deposition**

The Battle



Discovery Depositions

- **If the Department Deposits Your Witnesses, Depose the Department's Witnesses**
- **If the Department Seeks to Depose Your CEO or CFO, Issue Notices of Deposition to the Director or Commissioner or Even the Governor**
- **Such Action Often Helps Resolve Discovery Disputes**



The Battle

Discovery

- **Attempt to Incorporate Discovery Responses and All Documents You Intend to Rely on at Trial Into a Stipulation of Facts or Through Detailed Affidavits.**
 - **Saves Considerable Time and Expense**
- **But, Balance the Use of a Stipulation of Facts Against Telling Your Story to the Judge Through Live Testimony.**

The Battle



Summary Judgment Motions

- **Rarely are There Material Facts in Dispute in a Tax Case**
- **Upon Completion of Discovery, Consider the Use of a Motion for Summary Judgment to Resolve Some or All Legal Issues in the Case**
- **Motions for Summary Judgment Can Help Streamline a Case**
- **Affidavits Allow You to Tell the Story Through Your Key Witnesses with Precision and w/o Impeachment.**

The Battle



Expert Reports/Witnesses

■ Consider the Use of Expert Witnesses

- **The Question to Ask is Whether an Expert Can Provide a Qualified Opinion on an Issue That Will be Helpful to the Judge**
- **If You Believe the Judge Will Benefit From an Expert's Opinion, Use an Expert**

The Battle



Expert Reports/Witnesses

- **Consider the Use of Expert Witnesses**
 - **Examples of Where an Expert's Opinion May be Valuable Include**
 - **Distortion**
 - **Arm's-Length Pricing**
 - **Tax Policy**
 - **Valuation**

The Battle



Expert Reports/Witnesses

■ Consider the Use of Expert Witnesses

- **Local Rules Regarding the Qualification of Expert Witnesses and the Use of Expert Reports Must be Followed**
- **Failure to Follow the Rules Could Result in the Exclusion of Your Expert and His/Her Report**

The Battle



Expert Reports/Witnesses

- **Consider the Use of Expert Witnesses**
 - **Evaluate the Risk of Preparing an Expert Report (Disclosed Early in Discovery) with Having Your Expert Testify Without a Report.**



The Battle

Burden of Proof

- **The Term *Burden of Proof* Includes the Concepts of the Burden of Production and the Burden of Persuasion**
- **The Burden of Production, Also Called the Burden of Going Forward, is Satisfied by Evidence That is Sufficient to Enable the Trier of Fact to Reasonably Find in Favor of the Burdened Party**



The Battle

Burden of Proof

- **When the Burdened Party (the DOR) Introduces Sufficient Evidence to Establish Each Element of its Case, the Burdened Party is Said to Have Established its *Prima Facie* Case.**
- **The DOR's Introduction of its Notice Into Evidence is Sufficient to Establish its *Prima Facie* Case – the DOR is Presumed to be Correct.**
- **The Taxpayer Then Has the Burden to Establish by Competent Evidence that the Assessment is Incorrect.**



The Battle

Burden of Proof

- **Failure to Satisfy the Burden of Production Requires a Decision by the Court as a Matter of Law on the Issue Adverse to the Burdened Party –Typically the Taxpayer**

The Battle



Burden of Proof

- **Utilize the Testimony of Witness and Produce Documents to Satisfy the Burden of Production/Proof**
- **To the Extent Witnesses Testimony is Not Contradicted, Impeached, or Inherently Improbable, the Trier of Fact Cannot Arbitrarily Disregard It.**



The Battle

Burden of Proof

- **The Production of Evidence by the Taxpayer Sufficient to Meet its Burden Imposes on the DOR the Burden of Producing Evidence to Meet or Rebut the Taxpayer's Evidence.**
- **The Department's Failure to Do So Requires a Finding in Favor of the Taxpayer**



The Battle

Trial Briefs

- **Always Submit a Trial Brief**
 - **Your Initial Brief Affords You the Opportunity to Tell Your Story Your Way**
 - **Your Reply Brief, If Permitted, Allows You Attack the DOR's Argument and Gives You the Final Word**
 - **You Always Want the Final Word**



The Battle

Trial Briefs

- **Trial Briefs Should Include:**
 - **Table of Cases and Authorities**
 - **Introduction or Statement of the Case**
 - **Statement of the Issues**
 - **Clear, Favorable Statement of the Facts**
 - **Clear, Favorable Statement of the Law (Your Argument)**
 - **Conclusion**

The Battle



Witness Preparation

■ Prepare Your Witnesses

- Explain the Issues
- Review Their Testimony
- Remind Them to be Truthful
- Remind Them Not to Speculate If They Don't Know an Answer
- Prepare Them for Cross Examination

The Battle



Opening Statements

■ Make an Opening Statement

- Provides the Court With a Road Map of Your Case
 - Explain What You are Going to Prove at the Hearing and Why You Should Prevail
 - Do Not Ridicule the State's Position

The Battle



Closing Statements

■ Closing Statements Are Optional

- **If You Feel the Need to Make a Closing Statement, Make One**
- **However, if You Are Submitting Post-Hearing Briefs, Consider Saving the Court's Time by Summarizing Your Position in Your Trial Brief**



PART TWO



What are we doing here?

(Especially with Cocktail Reception Looming)

Lot of Expertise in This Room

Varied Jurisdictions and Personalities—One Size Fits All Solutions Are Difficult

Goal of This Portion of Presentation—Reminders of Substance and Process Approaches That Generally Pay Dividends

Focus on Pre-Litigation Issues

More Substantive Presentation Accompanies This One



Process Reminders

Process Lessons and Approaches

- 1. The Org Chart is Top Down—Results are Bottom Up**
- 2. It's a Long Season**
- 3. Tell the Story Early and Often (and Your Way)**
- 4. Here Today, Gone Tomorrow**
- 5. Be Like Boston (City of Champions)**
- 6. Process is Power (or Know the Rules)**
- 7. When Home Cooking Means Home Cooked**
- 8. Hope for Settlement, Prepare for Trial**
- 9. Wall Street Journal—Here We Come**
- 10. Leaving on a Jet Plane—The Value of Away Games**
- 11. When Clicking “Send” Can Cost You**



Process Reminder #1

The Org Chart is Top Down—Results are Bottom Up

Resist the Temptation to Skip Over the Line Auditor

Temporary Results (Maybe) at What Price?

Audience with Supervisor Still Must Overcome Inter-Office Support, and Risk of “Sellout”

Line Auditors Often Progress to Supervisor Level

**Caveat: Substantive Issues Rarely Settled at Auditor Level
(Requesting Permission to Discuss Substantive Issues with Those
That Make Departmental Policy is Rarely a Problem)**



Process Reminder #2

It's a Long Season

We Are All Competitive and Hate to Lose

Set Yourself Up for Potential Wins in Future by Being Professional and Graceful When You Lose

Live to Fight Another Day

With Client's Permission, Consider Pointing Out Computational Mistakes or Approaching Statute of Limitations

State Auditors Have a Difficult Job and Often Deal with Those Who Do Not Respect Their Efforts and Authority (always) be respectful



Process Reminder #3

Tell the Story, Early and Often (and Your Way)

Every stage of the contest, from early meetings with auditors to the final presentation before the trier of fact is an opportunity to tell the story your way

Many assessments are the result of misinformation or a failure to tell the full story

You have the facts, you control (and should control) the delivery of those facts



Process Reminder #4

Here Today, Gone Tomorrow

By the time a matter is taken to trial, the years to which the dispute relates may be distant history

The employees who control the facts may no longer be employees (and may have left under not the best circumstances)

Use of affidavits in the audit process and informal dispute resolution process

Well organized audit files are critical (retain them, retain the documents, document who understands the facts)



Process Reminder #5

Be Like Boston (City of Champions) **Free Agents Can Help You Win**

Know When You Need Help, and Hire the Best Person to Get Results
Consistent Hiring of Local Counsel to Assist
Big 4 Expertise

The Theater of Bringing in the Practitioner Can Break Logjams
Jeopardy Assessment and Repairing a Troubled Relationship

Invest in the Farm Team

Involve Younger Members of Audit Team and Outside Advisors Where Cost-Effective and Strategically Acceptable.



Process Reminder #6

Process is Power (or Know the Rules)

Statute of Limitations (Obviously)

How Long to Independent Voice?

Procedure May Drive How Facts and Law Are Presented

Consider Using Early Process as Test Run for Litigation, Not Only for that State But Sometimes as Trial Run for Where Issue Really Matters in Terms of \$ (California Versus New Hampshire)



Process Reminder #7

When Home Cooking Means Home Cooked

Choose Your Dispute Resolution Path Deliberately

**Use of “Local” Courts or State Controlled Internal Courts
Can Have Disastrous Results**

Don't Pay/Don't Pay/Don't Pay (But at what Price?)



Process Reminder #8

Hope for Settlement, Prepare for Trial

Most disputes end in settlement, but settlements often depend on being prepared for trial

Prepare, prepare, prepare (the one advantage you always have is to outwork the competition)

Get the Facts, Gather Witnesses Early



Process Reminder #9

Wall Street Journal—Here We Come

Increased Information Sharing Among States

Increased Public Distaste for “Corporate Tricks”

Increased Political Appetite for “Shutting Down Loopholes”

24/7 News Cycle



Process Reminder #10

Leaving on a Jet Plane—The Value of Away Games

In the Age of Electronic Communication, Personal Appearances Can Mean a Tremendous Amount in Repairing a Troubled Audit or Closing a Settlement.

Auditor: “First Time Someone Outside of This State Came to My Office to Work on Issues”

Unfortunately, Tone of Voice Often Dictated by Reader, Not Writer. Face to Face Allows Immediate Clarification Due to Other Attitudinal Evidence (Body Language, Actual Tone of Voice, Etc.)



Process Reminder #11

When Clicking “Send” Can Cost You

Era of Electronic Communication

Communication with Auditors and DOR Staff—Preferences and Risks

Avoid Disasters--Pretend It’s on Letterhead

Avoid Disasters--Tracked Changes Do What?



Substance Reminders

Substance Lessons and Approaches

- 1. Words Do Not Equal Numbers—Numbers Do Not Equal Words**
- 2. Wings are For Chickens**
- 3. Know When to Hold ‘Em, Know When to Fold ‘Em**
- 4. My Enemy Is Now My Friend**
- 5. Adverbs Do Not Reduce Your Tax Liability**
- 6. It’s Not Their Only Case (Part 1)**
- 7. It’s Not Their Only Case (Part 2)**
- 8. It’s All About the Benjamins**



Substance Reminder #1

Words Do Not Equal Numbers—Numbers Do Not Equal Words

Auditors Start with Numbers Only, Very Few Words on Tax Return

Chief of Multistate: We Are Looking for Anomalies and the Exceptions

IDR's are Words, but IDR's Often Purposely Do Not Integrate

As Practitioners, We Must Integrate Words with Numbers to Tie Up the Anomalies and the Exceptions

**Don't Give Auditors the Pieces and Expect Them to Solve the Puzzle—
Good Persuasive Writing Flips the $A+B+C=D$ Logic to: D Because of $A+B+C$**



Substance Reminder #2

Wings are For Chickens

Facts, Facts, Facts

Law, Law, Law

20 Minutes of Preparation for Every Minute of a Meeting

Often, Practitioners Have Resource Advantages that Can Help Resolve the Issues



Substance Reminder #3

Know When to Hold ‘Em, Know When to Fold ‘Em

Understand the Department’s Policy Concerns (Certain Substantive Positions Cannot be Settled)

One Time Issue vs. Continuing Impact

Right on the Substance, Wrong on the Facts/Equity

Group Settlement Discussions (Involve other Practitioners with Similar Issues)



Substance Reminder #4

My Enemy Is Now My Friend

Unlike Traditional Litigation, the Opponent Remains the Same

Need less (and Typically Useless) Depositions of Departmental Personnel Should Be Avoided

There Are Typically Two Sides to Every Issue, Be Respectful



Substance Reminder #5

Adverbs Do Not Reduce Your Tax Liability

Tempting to Let Frustration Show in Written Communication

Obviously, Clearly, Convincingly, Outrageously, Merely

Often Have the Exact Opposite Effect as Intended

**Writing Tip—Scrub All “LY” Words From Final Product—
Let the Facts and the Law Tell the Story**



Substance Reminder #6

It's Not Their Only Case (Part 1)

Just Like You, Auditors Have Lots of Cases and Matters to Attend To

Trying to Make Their Job Easier Can Make Your Job Easier

Travel Budgets Smaller, Make Field Audit Worthwhile

Rarely Seen the “Make Life Difficult” Strategy Work—the Power of the State to Issue Assessment



Substance Reminder #7

It's Not Their Only Case (Part 2)

Auditors May Not Tell You About Dynamics That Could be a Bar to Resolving the Matter:

- Confidentiality Concerns (Loss of Job and Criminal Violation)**
- Current Focus on Particular Types of Transactions**
- New Supervisors**

When Encountering Resistance, Explore These Dynamics and Strategize Whether You Want to Be at the Front or the End of the Line



Substance Reminder #8

It's All About the Benjamins

Despite All the Facts and the Law, Eye is On the Bottom Line for Both Parties

All States Are Not Created Equal

Approaches—Settlement Vs. No Settlement

Timing—Fiscal Situations (Know the State's Position and FYE)

Strategies for Difficult Fiscal Times

Strategies for Plentiful Fiscal Times