Managed Compliance Agreements

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Background

- What is a Managed Compliance Agreement ("MCA")?
  - Formal written agreement between a taxpayer and the state
  - Sales/use tax liability is determined based on a projection using taxpayer's historical data
  - Taxes are paid directly to the state taxing authority

Background

- MCAs are also referred to as:
  - Sales and Use Tax Compliance Agreements (SUTCA)
  - Managed Audit Compliance Agreements
  - Effective Use Tax Rate Agreements
  - Formulary Sales and Use Tax Agreements
  - Simplified Procedure Agreements
- MCAs should be distinguished from *Managed Audit Agreements*

History

- Initially MCAs were driven by taxpayers
- States, however, are recognizing the benefits of MCAs and many have implemented managed compliance programs
- A number of states have entered into MCAs with taxpayers

Statutory or Other Basis for MCAs

- Taxing authorities generally have some statutory authority to enter into MCAs
- Some states have statutes specifically authorizing such agreements
  - Example: Texas, Nebraska
- Other states have implicit statutory authority to enter such agreements

Managed Compliance Agreement – Overview of the Process

- Determine whether the taxpayer is an appropriate candidate
- Determine how to calculate the applicable tax and who is involved in the calculation
- Decide what accounts will be included in the tax base
- Decide how long the agreement will be in place and set up termination provision
- Decide how to address unusual transactions or changes in business operations

Managed Compliance Agreement – Overview of the Process

- Decide how to address changes in law, both prospectively and retroactively
- Set forth clear record keeping requirements
- Decide how to monitor the agreement
- Decide whether there will be a true-up at the end
- Decide what protest rights are available to the taxpayer
- Decide how to handle waiver of penalties and interest

Eligibility

- Large taxpayer
- High volume of taxable transactions
- Track record of complying with sales/use and other tax laws
- Acceptable record-keeping policies and procedures
- Has not filed for bankruptcy
- Has not been the subject of a criminal investigation
- Holds a direct pay permit or may obtain a direct pay permit

Managed Compliance Agreement – Base Period

- Select a base period and review purchases made during this period to determine the taxability ratio or the effective use tax rate
- Current audit period or a refund period is often used
- Must be representative of the taxpayer’s normal purchasing activity

Managed Compliance Agreement – Tax Base

- Determine which accounts should be included in the tax base
- MCA may include:
  - All of a taxpayer’s accounts, or
  - Only a small portion of the accounts

Managed Compliance Agreement – Tax Base

- Types of purchases the taxpayer and/or taxing authority may want to exclude:
  - Fixed assets
  - Single item purchases exceeding a threshold amount
  - Purchases for resale
  - Telecommunications or utility services
  - Certain exempt purchases
  - Major construction projects
  - Procurement card purchases

Managed Compliance Agreement – Sampling

- Typically used when the population of items to be examined is so large it is impractical to review each item individually
- Type 1: Quasi or non-statistical sampling
  - Judgment based sample selection process
- Type 2: Statistical sampling
  - Random sample selection process
  - Allows confidence level and precision to be specified
  - Typically 90-95% confidence level and 5-10% precision is desired

Managed Compliance Agreement – Sampling

- States vary in the types of sampling methods they allow
  - District of Columbia – block sampling
  - California and New York – statistical sampling
  - New Jersey – allows use of statistical, quasi-statistical, and non-statistical sampling
- Benefits of Sampling
  - More efficient and less expensive
  - Provides greater accuracy

What is True Statistical Sampling?

- <u>Every</u> item in the population has a positive chance of selection
- Sampled items selected using randomization techniques
- Sample is representative of the population
- Block sampling is <u>not</u> statistical sampling

What is True Statistical Sampling?

- Provides the smallest sample size for a given risk requirement
- Controls confidence and precision
- Backed by statistical sampling theory

Managed Compliance Agreement – Sampling

Stratum Analysis

Interval	Total Actual Amount	Total Absolute Amount	Percentage of Total Amount	Number of Items	Percentage of Total Items	Average Dollar Amount	Total Tax Accrued	Standard Deviation (Absolute Value)
0 - 50	$ 1,193,057.14	$ 1,203,892.64	0.89%	62,788	40.15%	$ 19.17	$ 24,751.41	14.43
50 - 200	4,019,874.64	4,056,982.06	3.00%	39,025	24.95%	103.96	85,367.72	41.73
200 - 700	10,437,490.26	10,552,133.02	7.79%	27,263	17.43%	387.05	241,203.02	138.02
700 - 2,000	**17,668,833.22**	**17,909,903.04**	**13.22%**	**15,267**	**9.76%**	**1,173.11**	**368,716.24**	**359.74**
2,000 - 5,000	22,075,287.82	22,307,749.06	16.47%	7,355	4.70%	3,033.00	441,584.09	856.58
5,000 - 13,300	25,466,824.19	26,017,390.29	19.21%	3,310	2.12%	7,860.24	609,616.21	2,321.37
13,300 - 37,500	22,653,725.87	24,059,464.81	17.76%	1,108	0.71%	21,714.32	373,830.84	6,677.88
37,500 - 9,999,999	23,781,904.78	29,356,962.14	21.67%	278	0.18%	105,600.58	170,014.17	38,977.54
Totals	**$127,296,997.92**	**$135,464,477.06**	**100%**	**156,394**	**100%**		**$2,315,083.70**	

Managed Compliance Agreement – Effective Taxable Percentage

- Effective taxable percentage is the percentage applied to a predetermined population of purchases (tax base) to arrive at taxable purchases
- Step 1: Determine the taxability ratio-the ratio of taxable purchases to total purchases in the population
- Step 2: Calculate the tax by multiplying purchases in the tax base for a given month by the percentage and applying the tax rate to it

Managed Compliance Agreement – Effective Taxable Percentage

- Example:
  - – Total tax base purchases for the population: $1,000,000
  - – Taxable purchases: $600,000
  - – Taxability ratio: 60%
  - – Tax base for the month $100,000
  - – Use tax rate: 5%
  - – Then,
  - – Taxpayer's use tax liability is $3,000

Managed Compliance Agreement – Effective Use Tax Rate

- Effective use tax rate is the rate applied to a predetermined population of purchases to arrive at use tax liability
- Step 1: Determine the tax due on the purchases in the population tax base
- Step 2: Calculate the effective use tax rate - Tax due on the purchases divided by the population of purchases
- Step 3: Multiply the purchases in the tax base for each month by the effective use tax rate to calculate tax due for each month.

Managed Compliance Agreement – Effective Use Tax Rate

- Example:
  - Total tax base purchases in the population: $1,000,000
  - Tax due: $30,000
  - Then,
  - Taxpayer's effective use tax rate is 3%
  - Total purchases in this month's base $100,000
  - Taxpayer's use tax liability is $3,000
  - Use tax rate: 5%

Managed Compliance Agreement – Term of the Agreement

- Taxpayer and taxing authority must agree on the term of the agreement
- Statute of limitations is the optimum time frame
- Can be structured for a shorter term initially with the option to extend
- MCA term varies by state
  - California: 3 years
  - Florida: 2 years
  - Michigan: 4 years

Managed Compliance Agreement – Local Tax Issues

- Issue 1: Counties or municipalities impose and collect their own sales/use tax rather than the state collecting such taxes
  - May require separate negotiations with the county or municipality
- Issue 2: Transactions that involve more than one county or municipality (e.g., purchaser is in County A and the seller is in County B) in a state with origination taxes

Managed Compliance Agreement – Record-Keeping

- Record-keeping requirements should be outlined in the agreement
  - Are reduced record-keeping requirements an option?
  - Manual or electronic records
  - Types of records that need to be retained

Managed Compliance Agreement – Amendments

- Changes in business operations
  - Shutdown or startup of manufacturing or support facilities
  - Transferring or absorbing activities of a contractor
  - Cost containment programs
  - Mergers and acquisitions
  - Financial or accounting changes
- Changes in law

Managed Compliance Agreement – Termination Provisions

- Termination provisions should be outlined in the agreement
- Reasonable notice requirement
  - For the taxing authority, relatively short notice may be sufficient
  - For the taxpayer, a longer notification period may be necessary as termination of the agreement may require the taxpayer to change reporting methods, retrain personnel, etc.

Managed Compliance Agreement – Monitoring the Agreement

- "True-up": Audit conducted at the end of the term of the MCA to determine if the actual tax reported under the agreement is different from the tax that would otherwise be due
- True-ups may be conducted by the taxing authority, the taxpayer, or a third party
- Underpayments and overpayments of tax are resolved
- New effective use tax rate is calculated and used for the next period

Managed Compliance Agreement – Dispute Resolution

- Agreement should address how disputes are to be handled
- Contract law should govern disputes regarding the terms and conditions of the agreement
- General protest rights under state law should still be available to the taxpayer

Benefits to the State

- Reduces audit costs
- Eliminates the need for full-scale tax audits
- Allows the state to focus on auditing those taxpayers who might otherwise avoid review
- Lessens the likelihood of expensive and time-consuming litigation
- Creates greater confidence in the reported sales/use tax
- Increases the level of taxpayer compliance
- Results in receiving tax funds a timely basis
- Creates opportunity to build positive relationships with the members of the business community

Benefits to the State

Generally, MCAs have tended to increase tax liability because:

- They require advance agreement on disputed transactions
- They may eliminate a taxpayer's ability to benefit from retroactive refund opportunities

Benefits to the Taxpayer

- Eliminates tax overpayments and fees associated with the recovery of overpayments
- Reduces time spent determining tax to be paid, allowing the tax department to focus on strategic matters
- Use tax becomes a budgetable expense for planning and allocation of the taxpayer's resources
- Limits risk of errors and associated interest and penalties

Benefits to the Taxpayer

- Reduces time spent on audit and audit-related activities
- Eliminates uncertainties associated with taking a particular position on an issue and the possibility of the state disagreeing with a particular position on audit
- Creates opportunity to build a positive relationship with the taxing authority

States that Don’t Currently Allow Direct Pay Permits

- Legislation can be enacted to allow both direct pay permits and MCAs
- Success Story: Connecticut
  - Department of Revenue Services set up a Managed Compliance Task Force
  - Task force first met in September 1998
  - Connecticut passed legislation allowing MCAs on June 22, 1999
  - Pilot program began in October 1999

Conclusion

Effective tool that streamlines the process

Should be utilized by more states and for more industries

Win-Win solution

Managed Compliance Agreements

Questions?